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THESIS

GAINING CONTROL OF IRAQ'S SHADOW ECONOMY

by

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September 2007

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GAINING CONTROL OF IRAQ'S SHADOW ECONOMY

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Submitted in partial fulfillment of the
requirements for the degree of

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ABSTRACT

Four and a half years after freeing Iraqi citizens from a ruthless dictatorship, the country is still mired in poverty, corruption and insurgent violence. These conditions fuel a sprawling, decades-old shadow economy manipulated by elements of organized crime, militias, and insurgents to fund attacks on Coalition forces, infrastructure and innocent Iraqi civilians. The shadow economy is also used extensively by the poor and women for subsistence living. The combined effect for Iraqi citizens is they have to survive in a country without adequate institutions and poor governance. The extensive shadow economy diverts funds from legitimate uses by the government such as taxes, funds for reconstruction projects, social protection, social insurance, etc. Numerous agencies are deeply committed to helping the Iraqi government rebuild and formalize the shadow economy. In this thesis I examine the challenges involved in formalizing a shadow economy in the midst of war and the strategies undertaken. I analyze similar efforts to restore peace and stability in Afghanistan with its burgeoning opium trade searching for successful approaches with applicability in Iraq.

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I. INTRODUCTION, LITERATURE REVIEW AND THEORETICAL FRAMWORK

A. INTRODUCTION

1. Iraq's Shadow Economy

Iraq's Shadow or Informal Economy needs to be formalized because it is a large and growing problem for Iraqi society. Growth and development is stifled. It serves as a hotbed for corruption, organized crime, black marketeering and in the four years since the U.S.-led invasion, as a logistical and financial support network for insurgent operations. The informal economy is largely unregulated, with few of the enforced standards which benefit citizens in most modern societies. Businesses that operate in shadow economies are generally not registered or under-report their incomes and employment levels. As a consequence, businesses are able to avoid taxation and, therefore, do not generate income for the state. This financial shortfall plays a contributing role in the lag experienced thus far in establishing government institutions which can be used to help heal the country's socio-economic shortcomings. It is a widely accepted fact that corruption and bribery are common contributing factors in an expanding shadow economy. Small businesses are less apt to develop into larger enterprises or corporations. Smugglers, gang members, organized crime and insurgents move easily within Iraq's Shadow economy. For a lack of better options, millions of Iraqis use the Shadow Economy as a venue for maintaining a subsistence level existence. Others, displaying more predatory behavior use it as an enabler for a variety of illegal activities. Insurgents use the Shadow Economy to create stumbling blocks for stabilization and reconstruction efforts to defeat their enemies.

By implementing the correct mix of public administration, federal regulation, and enforcement, the Iraqi Government can successfully formalize the continually expanding Shadow Economy. These measures along with an education plan can help minimize corruption and transform the economy into a national asset.

2. Methodology

To test this theory, I will follow the case study method using information and data from foundational sources such as the National Strategy for Victory in Iraq¹, Coalition Provisional Authority, Iraqi Constitution, International Monetary Fund and the United Nations. Since much has been written about Coalition force involvement in Iraq, stabilization and reconstruction efforts and the insurgency, secondary sources of information will come from scholars, journalists and authors.

Corrective measures initiated, for example, by the Paris Club initiative for debt forgiveness; the International Monetary Fund's economic reform plan, and the United Nation efforts to establish a compact between Iraq, neighboring countries and the international community² have been discussed widely and their effects as it pertains to the shadow economy will be reviewed further in this document.

The actions of the Coalition Provisional Authority and the recommendations of the Iraq Study Group Report are relevant to this study. As indicated in Table 1, the Coalition Provisional Authority developed an aggressive schedule help Iraqis build a functioning government, restore essential infrastructure and get the economy moving, post-invasion.³ However early efforts to restore stability to the country drew criticism for, 1) the decision to disband the Iraqi Army on May 23, 2003, essentially adding half a million men to the already long line of unemployed, and 2) for its decision to dismiss Ba'ath Party members and loyalists from government civil service jobs. This measure also added more than a hundred thousand individuals to the unemployment lines and inadvertently to the shadow economy and possibly the insurgency. Former soldiers abandoned by the government, disheartened by faltering reconstruction initiatives, proved viable recruits for the insurgency both for economic and social reasons.

¹ National Security Council, *National Strategy for Victory in Iraq*, November 2003. <http://www.whitehouse.gov/infocus/iraq/> (accessed April 22, 2007).

² Heartington Invest and Trade, Inc., "Iraqi Economy: International Compact with Iraq Focuses on Iraqi Economy," July 29, 2006, <http://www.portaliraq.com/newsarchive.php?m=7&y=2006> (accessed March 15, 2007).

³ Coalition Provisional Authority, *Coalition Historic Review 2003 – 2004*, <http://www.cpa-iraq.org/> (accessed April 22, 2007).

The Hamilton-Baker Report⁴ recommendations for restoring stability, reconstructing Iraq, and achieving peace in the region sparked serious debate⁵ as the economic and security situation in Iraq edged steadily toward civil war.

Altogether these writings advocated one course or another for the Iraqi government, but they also did something more. They served to frame Iraq's Shadow Economy, establishing borders, emphasize its depth and dimension and provide a tangible target for policy makers to focus on as the effort to gain control of the informal economy continues.

Table 1. Comparative Reconstruction Milestones for Post-Saddam Iraq and post-WWII Germany.

	<u>IRAQ</u>	<u>GERMANY</u>
Local Governments Installed	2 Months	8 Months
Independent Central Bank	2 Months	3 Years
Police Established	2 Months	14 Months
New Currency	2 ½ Months	3 Years
Training a new Military	3 Months	10 Years
Major reconstruction plan	4 Months	3 Years
Cabinet Seated	4 Months	14 Months
Full Sovereignty	1 Year	10 Years
New Constitution	2 ½ Years	4 Years
National Elections	3 Years	4 Years
War Trials	Pending	6 Months

⁴ James Baker and Lee Hamilton, Co-Chairs, *The Iraq Study Group Report: The Way Forward – A New Approach*, (New York: Vintage Books, 2006).

⁵ Robert Looney, "Introduction to the Special Edition of Strategic Insights on the Iraq Study Group," *Strategic Insights* VI 2 (March 2007); See also Robert Looney, "Beyond the Iraq Study Group: The Elusive Goal of Sustained Growth," *Strategic Insights*, VI 2 (March 2007); Abbas Kadhim, "Shi'I Perceptions of the Iraq Study Group Report," *Strategic Insights*, VI 2 (March 2007); Brendan O'Leary, "Iraq's Future 101: The Failings of the Baker-Hamilton Report," *Strategic Insights*, VI 2 (March 2007); and Jonathan Spyer, "Israel and the Iraq Study Group Report," *Strategic Insights*, VI 2 (March 2007).

Discussions on what is best for the Iraqi economy include topics as varied as the monetary exchange rate,⁶ proper handling of Iraq's Saddam-era debt,⁷ neoliberalism as a prescription for a battered economy.⁸ A key piece of the puzzle and a contentious subject relates to how oil profits can best be used to benefit the population⁹ Further, the insurgency¹⁰ and the deteriorating, tumultuous security situation in Iraq are all topics that have drawn the attention of politicians, journalists, and scholars over the past four years as billions of dollars have been spent, and thousands of Iraqi and Coalition force lives have been sacrificed to reconstruct and stabilize Iraq. The difficult problem is to determine the correct mix of socio-economic strategies to counter extremism in Iraq¹¹

The rational view calls for the priority to be given to quelling the insurgency through direct confrontation and diplomacy. The Iraqi judicial system and police force should take proactive steps to control corruption and organized crime. Simultaneously, the federal government should strive for progress on reconstruction, and regulate infrastructure and business if it is ever to formalize its expansive shadow economy.

⁶ Robert Looney, "A Monetary/Exchange-Rate Strategy for the Reconstruction of Iraq," *Middle East Policy* X, 3 (Fall 2003).

⁷ Martin A. Weiss, "Iraq's Debt Relief: Procedure and Potential Implications for International Debt Relief," *CRS Report for Congress* RL33376 (December 6, 2006).

⁸ Robert Looney, "The Neoliberal Model's Planned Role in Iraq's Economic Transition," *Middle East Journal* 57, 4 (Autumn 2003).

⁹ Robert Looney, "Can Iraq Overcome the Oil Curse?" *World Economics* 7 1 (January – March 2006).

¹⁰ Robert Looney, "The Business of Insurgency; The Expansion of Iraq's Shadow Economy," *The National Interest* (Fall 2005).

¹¹ Robert Looney, "Socio-Economic Strategies to Counter Extremism in Iraq," *Journal of South Asian and Middle Eastern Studies* XXIX 2 (Winter 2006).

II. BACKGROUND

A. IRAQ'S ECONOMY IN THE EARLY YEARS OF BAATH PARTY RULE

The country of Iraq began the 1980's with a promising economy, albeit under the rule of a ruthless dictator. During Saddam Hussein's first ten years as President of Iraq, the citizens of Iraq had benefited from his initiatives to modernize the country's infrastructure and improve Iraq's standing among the international community. Accelerated by profits from the third largest proven oil reserves in the world,¹² unemployment decreased sharply in urban areas and people living in rural areas flocked to the cities. A concerted effort had been made over the last ten years to educate the poor and women;¹³ a notable undertaking in a predominantly male-oriented society. This initiative created one of the best-educated populations in the Arab world. It had a sizable industrial sector, well-developed transportation system and a decent infrastructure. Thousands of miles of new highways were built to connect domestic and international trading centers. Railroad tracks connecting key points along logistic routes had been laid. The size of the civil government grew and women were employed in many important positions. Moreover, the country was enjoying the fruits of its labors as oil prices rose dramatically around the world. Per capita income was comparatively high (over \$3,600 in the early 1980s)¹⁴, the cost of living was low, and demands on the average citizen, minimal.

¹² Energy Information Administration, "Iraq's Energy Data, Statistics and Analysis – Oil, Gas, Electricity, Coal," June 2006 <http://www.eia.doe.gov/emeu/cabs/Iraq/Oil.html> (accessed May 26, 2007).

¹³ Amal al-Sharqi, "The Emancipation of Iraqi Women," in Tim Niblock, *Iraq: The Contemporary State* (Manuka, AU: Croom Helm Ltd, 1982), 74-87.

¹⁴ World Bank, "Iraq," <http://web.worldbank.org/> (accessed June 23, 2007).

B. THE INEVITABLE RISE OF IRAQ'S SHADOW ECONOMY

1. 2007 World Bank Worldwide Governance Indicators

According to the 2007 Worldwide Governance Indicators project¹⁵ however, the Ba'ath Regime demonstrated many symptoms that contributed to the growth and development of shadow economies.¹⁶ Governance measurement follows a normal distribution with a mean of zero and a standard deviation of one in each period. Almost all of the country scores lie between -2.5 and 2.5 with higher scores indicating better adherence to good governance practices. As demonstrated below, one can see that Iraq adhered to several practices that boded ill for the state in the long run giving rise to an inevitable increase in the size of the shadow economy.

Voice and accountability. Measures citizens' ability to participate in selecting their government, as well as freedom of expression, association and freedom in the media. Iraqi citizens were afforded little opportunity to participate selection of governing bodies. In fact the opposite was true. The only groups allowed to participate were those powerful enough to win concessions from Saddam Hussein, like the Kurd People in the north of the country, and for a time the Communist Party. (2006 World Governance Indicator: -1.47 vs. 1996 -1.80)

Political Stability and Absence of Violence. This is a measure of the perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means including domestic violence or terrorism. Saddam Hussein was always wary of assassination attempts and coup d'états and was quick to use violent means to suppress suspected initiatives. For instance, he executed General Hussein Hiyawi, commander of the Air Force in the early 1970s. In 1993 he executed General Raji Abbas al-Tikriti, ex-commander of the army's medical corps and Jasim Amin Mukhlis, nephew of the famous Mawlud Mukhlis – suspecting them of hatching a

¹⁵ Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi, "Governance Matters VI: Governance Indicators 1996-2006 (July 2007)." *World Bank Policy Research* (Working Paper No. 4280) <http://ssrn.com/abstract=999979> (accessed August 1, 2007).

¹⁶ Robert Looney, "Iraq's Shadow Economy," *RISEC*, 52 4 (2005) 561-579.

coup against him. An attempted coup d'état in 1990 by the Jubbur also resulted in numerous arrests and executions.¹⁷ (2006 World Governance Indicator: -2.82 vs. 1996 No Data).

Government Effectiveness. Measures the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. The government was by far the largest employer in Iraq, even passing a labor law mandating full employment until it was repealed in 1987. However most of the government institutions and state owned enterprises were largely inefficient. (2006 World Governance Indicator: -1.64 vs. 1996 No Data).

Regulatory Quality. Measures the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. The Ba'ath Regime required a command or central economy. Foreign trade was restricted, all imports were handled by government contract. The two primary state banks, Rafidain and Rasheed, provided banking services and interest-free loans and grants to the regime rather than financing entrepreneurial growth and development in the public sector. Many Iraqi's admitted to never having seen the inside of a bank, preferring to use the informal hawala method of transferring funds and relying on relatives and tribal networks for loans. (2006 World Governance Indicator: -1.61 vs. 1996 -2.38).

Rule of Law. This indicator measures the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police and the courts, as well as the likelihood of crime and violence. No individual or ethnic group could feel safe under Saddam Hussein's rule. A centralized, closed economy encouraged corrupt practices and weak institutions undermined normal regulatory standards. The Kurdish people were killed en masse or relocated to other parts of Iraq to diminish their power base. Shiite religious leaders were hunted down, imprisoned, tortured and killed. Some were even hunted down across international

¹⁷ Amatzia Baram, "Saddam's Power Structure: the Tikritis Before, During and After the War." in Toby Dodge and Steven Simon. *Iraq at the Crossroads: State and Society in the Shadow of Regime Change* (New York: Oxford University Press, 2003), 97-99.

boundaries. Mass graves discovered after the 2003 invasion and countless stories of persons spirited away by thugs working for the regime, were a testimonial to the extreme level of oppression and disregard for justice or human rights. (2006 World Governance Indicator: -1.81 vs. 1996 No Data).

Control of Corruption. Measures the extent to which public power is used for private gain, including both petty and grand forms of corruption, as well as the “capture” by the state by elites and private interests. Power was wielded by a small Sunni minority. Networks were almost completely tribal and at the center was Saddam Hussein. Through him, and despite the social and technological advances that he initiated, corruption, smuggling, theft and brutality thrived. (2006 World Governance Indicator: -1.27 vs. 1996 -1.45).

Of the six governance data sets described above, Iraq ranked lowest in three areas; Political Stability and Absence of Violence (-2.82), Rule of Law (-1.81), and Government Effectiveness (-1.64). Slight improvements have been achieved in the areas of Voice and Accountability, Regulatory Quality and Control of Corruption.

2. Governance Factors Contributing to Iraq’s Shadow Economy

So unfortunately, the high per capita income did not play a key role in determining the size of the informal economy. Longstanding practices that still exist such as those mentioned above; relying on organizations like waqf’s throughout the Middle East to provide basic social services; and a lack of modern institutions contributed to a lagging economy despite a period of prosperity in the 1970’s.¹⁸

In Iraq, events took a turn for the worst when in 1980, Iraq entered upon a war with neighboring Iran.¹⁹ The eight-year war had a serious debilitating effect on Iraq’s economy. Financing the war was very expensive, costing billions of dollars. At the beginning of the war Iraq was almost entirely free of foreign debt and had \$35 billion dollars in foreign reserves. These reserves were exhausted in the first years of the war.

¹⁸ Timur Kuran, “Why the Middle East is Economically Underdeveloped: Historical Mechanisms of Institutional Stagnation.” *The Journal of Economic Perspectives* 18 3 (Summer 2004): 71-90.

¹⁹ Nita M. Renfrew, “Who Started the War?” *Foreign Policy* 66 (Spring 1987): 98-108.

By the time hostilities ceased, and following Iraq's expulsion from Kuwait Iraq's foreign debt exceeded \$45 billion although the actual figure varies widely. Several factors including; the drop in oil prices in the mid-1980's; the long duration and expense of the war, and; the perceived Iranian threat to the region, resulted in Saddam borrowing heavily from neighboring Arab countries, i.e. Kuwait, Saudi Arabia and the United Arab Emirates.

In June 1987, the Iraqi government abolished a labor law which guaranteed full employment. The government made redundant thousands of government workers and began to privatize state owned enterprises.²⁰ Economic sanctions forced the Iraqi government to reduce the size of its civil service. As in other oil rich countries, the government had employed a large percentage of the population; men in public administration, wholesale and retail trade and agriculture; women in education, agriculture and public administration. As a result there was little incentive for people to seek employment in the private sector. Further, the private sector could not compete with higher government wages or benefits. A long term condition, the private sector was inadequately prepared when the economy began to falter as a result of United Nations sanctions, or later when the Ba'ath regime was displaced.

Projects and development plans launched prior to the war went uncompleted. Essential maintenance to the country's power grids, roads, oil pipelines deteriorated. One million war dead on both sides left hundreds of thousands of women alone earn a living for their families. Education ceased to be a priority. According to a Federal Reserve Bank of Boston Public Policy Discussion Paper, due to the literacy campaigns of the 1970's and 1980's, illiteracy had been reduced from 48 percent in 1978 to 20 percent in 1987 among 15-45 year-olds²¹.

By 1991, all of these programs had ceased. In March 1991, the Iraqi army had been driven from Kuwait and Iraq had been bombed extensively. The Ba'athist regime

²⁰ Jonathan E. Sanford, "Iraq's Economy: Past, Present, Future," *CRS Report for Congress* RL 31944 (June 3, 2003).

²¹ Christopher Foote, William Block, Keith Crane, and Simon Gray. "Economic Policy and Prospects in Iraq," *Journal of Economic Perspectives* 18 3 (Fall 2004): 6-7.

was seriously challenged in the uprisings that followed but were able to maintain control, in particular because many Republican Guard divisions and elite units had managed to return from Kuwait with armor and weapons. Saddam Hussein appointed his cousin Ali Hasan al-Majid as Interior Minister to squelch the rebellion and restore order. The Republican Guard first secured Basra and petrochemical industries in the south then did the same in the north. Their violently, aggressive actions initiated a mass exodus in the country, the first of many that continue to the present. Execution, kidnapping were frequently reported to U.S. military forces.

The economy and the infrastructure had suffered greatly during the war and efforts at reconstruction proved near impossible. It was difficult for aid agencies to determine whether the damage and poor conditions they found in Iraq were caused by the 1991 war, the uprisings and economic sanctions that followed, or the Iran-Iraq War.²² Coalition bombing did more damage to the civilian infrastructure than anticipated. Damage to electrical generators caused a country-wide failure in water and sanitation systems and adversely affected healthcare facilities and other essential services. Incidents of crime rose as hospitals, water department offices, schools, and stores were looted; emptied of equipment, spare parts and supplies, all difficult-to-replace items. The Iraqi Government launched a three-month campaign to restore basic services and infrastructure in April 1991. Roads, bridges, telecommunications, electricity and water services were given priority but cannibalization proved the main method of restoration. Consequently, services deteriorated after two or three years since the number of available facilities were reduced and additional burdens were placed on the operating facilities. By 1994 electricity was in short supply with frequent blackouts in Baghdad. Similarly, water treatment plants were operating at half of full capacity. Basra's water supply was found to be contaminated, unsuitable for human consumption in 1996. Sewage systems deteriorated further because of a lack of spare parts for pumping stations and chlorine for treatment. A United Nations report disclosed that by 1995 the Iraqi Government was

²² Sarah Graham-Brown, *Sanctioning Saddam: The Politics of Intervention in Iraq* (London: I. B. Tauris & CO Ltd., 1999), 153-172.

only spending \$8.5 million on water and sanitation services, where in the years prior to 1991 the country had allocated \$100 million to these areas.²³

The government responded by initiating several high visibility projects to improve the morale of the populous and demonstrate its leadership. The Ministry of Defense headquarters was rebuilt and opened its doors in 1994. Construction on Saddam Tower, a gigantic communications tower in central Baghdad began in March 1995. Shrines in Najaf and Karbala were repaired and roughly about the same time new palaces were built for Saddam Hussein. Fresh water canal projects were also initiated but with little effect.

Economically, Iraq was in an uncontrolled tailspin. The population had increased from 16 million to 22 million between 1987 and 1997. Gross Domestic Product had gone from \$8.7 billion in 1960 to \$54 billion in 1979 then back down to \$10 billion in 1993. Imports shrunk from \$11 billion in 1980 to \$500 million in 1996. Exports also dried up; dropping from \$28 billion to \$500 million in 1996.²⁴ With only minimal reconstruction efforts going into the infrastructure, including new construction and maintenance of school buildings, the illiteracy rate was back up to 55 percent among 15-24 year-olds by 2001.²⁵ With insufficient income being generated for the treasury and mounting inflation, Iraqi citizens turned to other means to survive. Smuggling increased along all of Iraqi borders with routes continually changing based on the enforcement mood of the government. In 1991 the U.S. Dollar was worth only eight Iraqi Dinars but by December 1995 one dollar bought 2950 Iraqi Dinars. Earlier that year, Saddam Hussein authorized a ID250 note to be printed but by then it was worth less than .50 cents. Therefore, most trade took the form of barter. Oil and gas, fertilizer and cement were traded in Iran and Turkey for food, medicine and spare parts.

²³ United Nations Consolidated Inter-Agency Humanitarian Programme in Iraq: Extension of the Cooperation Programme for the period 1 April 1996 – 31 March 1997. http://www.reliefweb.int/OCHA_ol/pub/appeals/96appeals/iraq/irq_app.html#1.1 (accessed August 12, 2007).

²⁴ Sarah Graham-Brown, *Sanctioning Saddam: The Politics of Intervention in Iraq* (London: I. B. Tauris & CO Ltd., 1999), 161.

²⁵ Christopher Foote, William Block, Keith Crane, and Simon Gray. "Economic Policy and Prospects in Iraq," *Journal of Economic Perspectives* 18 3 (Fall 2004): 7.

Most of the goods that the Iraqis needed were available but inflation had driven them beyond reach. The agriculture industry suffered from a lack of quality seeds, harvest machinery, spare parts, poor drainage and high levels of salinity, to name a few. This led to food rationing. People were given monthly allotments of flour, rice, sugar, oil, tea, soap and detergent. Baby milk was also provided but only for babies under a year old. Many of the ingredients of the food baskets were sold by the families to purchase other needed goods. But even the food rationing system contained a political edge. The government reportedly placed restrictions on access to ration cards by denying cards to families of deserters and refugees, to individuals with criminal records. Ba'ath Party members reportedly received larger portions of rationed items and had food baskets delivered to their home.²⁶

These prolonged conditions proved an ideal incubator for corruption, black marketeering, smuggling and organized crime. It was during these trying twenty-odd years that Iraq's Shadow Economy came into its own and gained momentum. By 1998 the size of the Shadow Economy in Iraq was estimated at 68.3 percent of the labor force, and 32.2 percent of the total population.²⁷ Because the regime was so heavily involved in legal and illegal practices rampant in Iraq the formal and informal economies overlapped to a great extent. Contractors, transportation agents, and merchants profited the most. Reconstruction projects routinely went to contractors with close ties to government leadership through tribal, family or other social connections. These relationships survived the Ba'ath Regime and continue to the present day.²⁸

²⁶ Sarah Graham-Brown, *Sanctioning Saddam: The Politics of Intervention in Iraq* (London: I. B. Tauris & CO Ltd., 1999), 169.

²⁷ Robert Looney, "Economic Consequences of Conflict: The Rise of Iraq's Informal Economy." *Journal of Economic Issues* XL 4 (December 2006).

²⁸ Christopher Parker and Pete W. Moore. "The War Economy of Iraq." *Middle East Report* 243 (Summer 2007). http://www.merip.org/mer/mer243/parker_moore.html (accessed August 12, 2007).

3. Adverse Effects of Iraq's Centrally Managed Economy

The centrally managed economy was at least one significant factor in the development of the Iraq's Shadow Economy. A 2003 Report to Congress²⁹ listed the top ten imports in 1989 as follows, all of which were closely controlled by the government;

- Wheat
- Tractors
- Iron and steel
- Cattle, oxen and sheep ((bovine meat)
- Passenger vehicle motors
- Iron and steel
- Rice, milled
- Alloy steel bars, rods
- Medicaments
- Metal structures and parts

According to the report, all transactions had to be conducted through government contracts. Little or no private sector trade flowed across the borders thus setting the stage for corrupt practices. This system allowed the Ba'th Party to easily control the numerous state owned enterprises (SOE) and to influence extensively, the formal Iraqi commercial businesses. Centrally Planned or Command Economies are distinctive for the absence of legal, political, economic, and regulatory institutions that make for successful market economies. Iraq's centrally planned economy was heavily influenced by incomes generated by her oil industry. Displaying classic signs of an oil rentier state, the government placed more emphasis on deciding how to distribute the oil wealth and subsidizing necessities and placating the large sector of the population that was employed

²⁹ Jonathan Sanford, "Iraq's Economy: Past, Present, Future," *CRS Report for Congress* RL 31944 (June 3, 2003), 35.

by or dependent on, the state. The citizens would have been better served had the government dedicated itself to creating high-quality institutions to support a self-sustaining economy.

The lack of reliable institutions had a far-reaching detrimental impact on the economy. As the population grew, the number of opportunities grew scarce as sanctions took their toll. More people moved into the cities, by 1997 approximately 31 percent lived in Baghdad and the surrounding areas. A more current estimate places more than 65 percent of the population in towns and cities.³⁰ Young adults entering the job market for the first time faced tough challenges in trying to find a job in a stagnant formal sector. Jobs offering higher wages and benefits have been scarce since economic sanctions began to affect the economy. Given this situation, the alternative has been to find employment in the informal sector.

Table 2 shows the new categories of the Heritage Foundation/Wall Street Journal 2007 Economic Freedom Index. Iraq was not included in the world standings because economic data was closely guarded under the Ba'ath regime and reliable data is still not available. Since the 2003 invasion, economic recovery has been slow. The prevailing instability was largely due to fragmented ethnic and religious groups and insurgent violence. Iraq was last graded in 2002 when it received a score of 0 percent.³¹ Despite the fact that economic freedoms can not be accurately measured yet because Iraq's troubled, transitional economy is still in its infant stages, persistence in collecting and reporting data will enable the Iraqi Government and international agencies to gauge the effects of implemented policies and regulations on the size of the shadow economy in the future. Sufficient evidence exists to substantiate the need for major improvements in governance and economic freedoms if the shadow economy is to be controlled and converted into a formal economy, into a national asset.

³⁰ Robert Looney, "Economic Consequences of Conflict: The Rise of Iraq's Informal Economy," *Journal of Economic Issues*. XL 4 (December 2006).

³¹ Tim Kane, Kim R. Holmes, and Mary A. O'Grady, "2007 Index of Economic Freedom." *The Heritage Foundation and The Wall Street Journal*. (November 2006).

Table 2. Comparison between old and new Heritage Foundation/Wall Street Journal 2007 Economic Freedom Index.

10 Factors <i>Old Methodology</i>	10 Freedoms <i>New Methodology</i>
Regulation	Business Freedom
Trade Policy	Trade Freedom
Fiscal Burden	Fiscal Freedom
Government Intervention	Freedom from Government
Monetary Policy	Monetary Freedom (80%)
Wages and Prices	Monetary Freedom (20%)
Foreign Investment	Investment Freedom
Banking and Finance	Financial Freedom
Property Rights	Property Rights
Informal Market	Freedom from Corruption
N/A	Labor Freedom

4. Conclusions

Unfortunately it is reasonably easy from a superficial perspective to chart the disintegration of Iraq's formal economy into a substantial shadow economy over the course of three decades. In view of the foregoing, it appears that the Iraqi economy suffered from poor governance and prohibitive economic practices. Corruption played a key role in developing the shadow economy but Political Instability, Violence and lack of the Rule of Law play a larger role in its continued existence and growth. Government initiatives to modernize Iraq and educate its citizens were short-lived and resources were quickly overwhelmed by the demands of the eight year war with Iran. With the country deeply in debt, Saddam Hussein sought relief through debt forgiveness. When these efforts failed to produce the desired results and feeling his power base threatened he decided to invade Kuwait using the logic that the lands occupied by that country had belonged to Iraq prior to World War I. Further, he accused Kuwait of stealing Iraqi oil by slant drilling across their shared border.

This brazen act spurred the international community into action and resulted in an additional ten years of severe economic scarcity for the Iraq citizens. Social and survival networks developed during the war against Iran transformed into a coping economy

supported and fed off of by smugglers, organized crime and gang members. At its worst, the Iraqi government appeared to cease enforcement and regulation laying a foundation upon which an insurgency could grow.

Following the invasion of Iraq in March 2003 and the overthrow of Saddam Hussein and the Ba'ath Party regime, and the failure of the Coalition forces to establish and maintain security, an anarchic situation set in. Conditions worsened when the Iraqi Army was disbanded and thousands of civil servants loyal to Ba'ath Party were dismissed. These actions provided an opportunity for a Sunni-led insurgency and embroiled the country in disastrous internal conflict.

Iraq, weakened to the point of failure by years of war, sanctions, and poor administration and plagued by ethnic fighting, militias, and insurgency moved steadily toward civil war. Social and survival networks once interested only in a coping economy saw a new element surface, a combat economy. Iraq's formal economy continued to shrink as citizens lost confidence in government institutions and Coalition forces. Illiteracy rates among Iraqi youth (15-24) reached 55 percent in 2001, fueling a shadow economy that just three years earlier encompassed 68 percent of the labor force and 32.2 percent of the total population. It was a dire situation.

C. MANIPULATION OF THE SHADOW ECONOMY

In an interview with Reuters in Baghdad on October 17, 2006, a Sinan Youssef, senior official in the strategy department of the Iraqi Ministry of Labor and Social Affairs reported that 5.6 million Iraqis are living below the poverty line. At least 40 percent of these individuals are destitute. These figures represent a 35 percent increase over the level before 2003.³² To add depth to these dismal figures, the World Food Program warned that if the situation was not controlled via Public Distribution System (PDS)

³² Reuters AlertNet. "Iraq: Unemployment and Violence Increase Poverty." Source IRIN (October 17, 2006). <http://www.alertnet.org/thenews/newsdesk/IRIN/c14c2cc0f6c99e87f284df922a039cad.htm>. (accessed August 8, 2007).

rations an additional 8.3 million Iraqis would become “food insecure.” Further, the consumer rate of inflation in 2006 was reported as being between 50 and 64.8 percent.³³

The preceding are current figures, but manipulation of the Shadow Economy is longstanding, took many forms, and derived from several different motivations. Actors on both side of the law from the highest levels of government to petty criminals used the informal economy to their advantage. The Ba’ath Party regime led by Saddam Hussein was complicit in abusing the governmental institutions (i.e. national banks to obtain free or interest-free loans for certain party members). He was also proactive in obtaining kickbacks from other countries for allowing them to purchase oil from Iraq during the United Nations authorized Oil-For-Food Program. He was motivated by wealth and the desire to demonstrate to his countrymen that he was still in control. In 30 years of corruption and coercive practices, his regime effectively destroyed the underpinnings of civil society.³⁴

Others followed his lead or sustained trading and smuggling practices that had originated centuries before when Mesopotamia was crisscrossed by different branches of the Silk Road. For about two thousand years, silk, cotton, wool, glass, jade, lapis lazuli, metals, salt, spices, tea, herbal medicines, fruits, flowers, horses, and musical instruments were moved by caravan through what is now the country of Iraq from China to Italy.³⁵ As one can see from Figure 1, Iraq is almost entirely landlocked with shared borders to Iran (900 miles), Turkey (218), Syria (375), Saudi Arabia (500), and Kuwait (150) making cross-border smuggling difficult to control. When it suited Saddam Hussein, he encouraged tribal leaders to resume their smuggling efforts, particularly when Iraq was

³³ CIA World Fact Book <https://www.cia.gov/library/publications/the-world-factbook/geos/iz.html>. (Accessed August 8, 2007) and Michael O’Hanlon and James Campbell, “Iraq Index: Tracking Variables of Reconstruction and Security in Post-Saddam Iraq,” *The Brookings Institution* (May 10, 2007).

³⁴ Ali Ameer Abdul Allawi, “Civil Society in Iraq at Work Amid the War” (*Heritage Lectures published by the Heritage Foundation*, April 26, 2006) <http://www.heritage.org/Research/MiddleEast/Iraq.cfm> (accessed June 16, 2006).

³⁵ Richard Kurin, “The Silk Road: The Making of a Global Cultural Economy,” *Smithsonian Magazine* 23 1 (Winter/Spring 2002).

subject to economic sanctions. Of course, smugglers needed little prompting from the government to use established smuggling routes and the shadow economy to make a profit.

Figure 1. Map of Iraq



Source: CIA maps, provided by the Perry-Castaneda Library, at <http://www.lib.utexas.edu/maps/iraq.html>

Figure 1. Map of Iraq

As the security situation worsened in Iraq, third generation gangs evolved into organized crime units and developed networks with insurgents. The informal economy proved an ideal logistics framework for their activities as well. However, many Iraqi citizens resorted to using the shadow economy through sheer need. The conditions mentioned above were carried out across three phases of informal economies each with its own particular brand of customers and players.³⁶ Table 3 is a variation of the chart which was cited in Robert Looney's article, "The Economics of Coping: The Plight of Women in Iraq's Informal Economy." It was originally developed by Jonathan Goodhand in a study of Afghanistan's informal economy to demonstrate the categories, uses and actors in each.³⁷ In the original chart, the Combat Economy was placed in the primary position and tailored to fit the events in Afghanistan at the time. Events in Iraq tended to reflect a progressive transition from a Coping Economy to a Shadow Economy then a Combat Economy. This and a few other details specific to this country have been modified accordingly.

Under the Ba'ath Regime one might imagine the "have-nots" demonstrating behavior that would fit into a Coping Economy. As the 1980's drew nearer, the population in the urban areas grew and the potential for profit by profiteers, smugglers black marketers, etc., increased, interaction within the informal economy increased creating a larger Shadow Economy. These phenomena developed into a Combat Economy following the 2003 invasion by Coalition Forces and the rise of the Sunni-led insurgency.

³⁶ Robert Looney, "The Economics of Coping: The Plight of Women in Iraq's Informal Economy," *The Journal of Social, Political and Economic Studies* 30 3 (Fall 2005).

³⁷ Jonathan Goodhand, "Frontiers and Wars: A Study of the Opium Economy in Afghanistan," (Draft, University of London, (January 2003).

Table 3. Informal Economies in Iraq

Economics, Actors, Motives and Activities			
	The Coping Economy	The Shadow Economy	The Combat Economy
Who? Key Actors	Poor families living in rural and urban areas	Profiteers, Gangs, Organized Crime, Transport Sector, Businessmen, Smugglers	Militia Commanders, "conflict entrepreneurs" Insurgents, 3G Gangs, Organized Crime, fighters, Suppliers of AA&E
Why? Motivations and Incentives for War and Peace	To cope and maintain asset bases through low risk activities, or to survive through asset erosion. Social Insurance and/or Peace could enable families to move beyond subsistence.	To make a profit on the margins of a conflict. Effective government institutions, Social Insurance and/or Peace could be in their interest if encourages longterm investment. Investment and licit entrepreneurial activity. Government intervention and Pea	To fund the war efforts or achieve military objectives. Peace may not be in their interest as it may lead to decreased power, status, and wealth. Combatants and other actors may have an interest in peace if there are other ideological, political, and ma
How? Key Activities and Commodities	Employment of diverse strategies to spread risk; subsistence agriculture; petty trade and small businesses; on-farm and off-farm wage labor; labor migration and remittance; redistribution through family networks.	Smuggling of high-value commodities; mass extraction of natural resources; hawalla (currency order and exchange system); aid manipulation.	Taxation of licit and illicit economic activities: money, arms, equipment; economic blockages of dissenting areas; asset stripping and looting; kidnapping and aid manipulation

1. Iraq's Coping Economy

Iraq's Coping Economy is the most guiltless of the three types of informal economies because it reflected the initiative of the poor who were determined to survive in a regime which did not provide sufficiently for their social welfare. The Iran/Iraq War took its toll on the economy. Unemployment followed quickly on the heels of war as the army was reduced in size and small businesses and parts of the industrial sector collapsed from a shortage of electricity and spare parts. A survey conducted in 1996 estimated that monthly salaries declined by 56 percent between 1991 and 1996; more for mid-level civil servants.³⁸ Inflation resulted in a loss of earning power, and women traditionally teachers and pharmacists or who would not have normally worked prior to 1990, began

³⁸ Sarah Graham-Brown, *Sanctioning Saddam: The Politics of Intervention in Iraq* (London: I. B. Tauris & CO Ltd., 1999), 186-187.

entering informal job markets such as selling goods, cleaning and working from home. Men that were not employed by the state took jobs as taxi drivers, repair and construction work and the like. Austere times call for innovative measures. Iraqi citizens with access to special government stores began to sell their purchases to those waiting outside for higher prices and taxi drivers started carrying other goods for sale or to use as bribes. So as the name indicates, the Coping Economy started mainly with Iraqi citizens living below the poverty line and included activities used to feed themselves where social welfare, government or civilian employment was unavailable then progressed from there. For example, one might expect individuals caught up in a coping economy grow their own fruits and vegetables and raise some farm animals for consumption or sale. Surplus goods were traded within the community for money or bartered for other goods and services. Other practices included handy work when opportunities arose, food service and other forms of general labor as part of small family-owned enterprises. But as conditions worsened other characteristics emerged, prostitution reportedly increased.³⁹ Families found it necessary to sell their property and family possessions; some even the clothes they owned to buy food and other necessities. Selling jewelry became common as did participation of all family members (including children) in working to earn a living.

One theme transcends all three types of informal economies: the more widespread the informal economy the fewer tax revenues are generated for the state. This undermines the abilities of states to finance the provision of basic goods and services and in the case of Iraq, during periods of economic sanctions, war and transition, the additional challenge of providing security.⁴⁰

³⁹ Christian Caryl, "Iraqi Vice." *Newsweek: War in Iraq* (December 22, 2003). <http://www.msnbc.com>. (accessed August 16, 2007), Arwa Damon. "Iraqi Women: Prostituting Ourselves to Feed Our Children." *CNN.com* (August 16, 2007) <http://www.cnn.com> (accessed August 16, 2007), "IRAQ: Poverty Drives Children to Work for Armed Groups." *IRIN UN Office for Coordination of Humanitarian Affairs* (May 10, 2007). <http://www.irinnews.org/IRIN-ME.aspx> (accessed August 16, 2007), and Clare M. Ribando, "Trafficking in Persons: U.S. Policy and Issues for Congress." *Report for Congress* RL 30545 (June 20, 2007).

⁴⁰ Heiko Nitzschke, "Transforming War Economies: Challenges for Peacemaking and Peacebuilding." *Economic Agendas in Civil Wars; Report of the 725th Wilton Park Conference, in association with the International Peace Academy, Wiston House, Sussex, England.* (December 2003).

2. Iraq's Shadow Economy

The Shadow Economy in Iraq is more sophisticated than the Coping Economy in that it includes a much wider spectrum of contributing factors and informal activities conducted outside of state-regulated structures. These activities include the purchase and sale of goods and services that under normal circumstances would fall into both realms, legal and illegal. Principals in this setting are more apt to be members of organized crime, gangs, or petty criminals but also include those members participating in the Coping Economy. They take advantage of opportunities that began to present themselves during the unregulated period that developed during the Iraq/Iran War. In fact the Shadow Economy was credited for propping up the economy during the war and for several years following its conclusion.⁴¹ Austere economic conditions persisted through the rise of the insurgency in late 2003 to the present day creating optimal conditions for all manner of products to be sold in the shadow economy. Small family-owned businesses operated without required licenses to avoid detection by the government, gangs and organized crime. If an operating license was obtained, income and employment levels were frequently underreported for similar reasons, and to maximize profit.

By 1993, theft and bribery had become a routine means of survival. Incidents of auto theft increased; many times accompanied by murder to eliminate possible witnesses. Police and civil servants were prone to bribery. The police were reported to solicit protection money from shopkeepers. Lawlessness became so rampant that the regime imposed severe punishments for misdemeanor crimes. In January 1992, the death penalty was imposed for theft, burglary and looting.

Street vendors normally operate without a permit and today, in a potentially hazardous environment. The fact that they break the law by selling pirated CD's, illegally acquired medication, and stolen electronic equipment is minuscule compared to the dangers they face in the form of suicide bombers who view public markets as a target-

⁴¹ Robert Looney, "The Economics of Coping: The Plight of Women in Iraq's Informal Economy." *The Journal of Social, Political and Economic Studies* 30 3 (Fall 2005).

rich environment. The Brookings Institute reported 76,500 Iraqi civilians killed by violence during the time period May 2003 to December 31, 2006. This figure which does not include military personnel, Iraqi police, police recruits, or Iraq Civil Defense Forces is cited to demonstrate the blurred lines between the shadow and combat economies.⁴² This figure is not intended to cast a pall over the business of street vending but suicide bombers using explosive vests, incendiary explosive devices and car bombs are known to seek out densely populated centers, public gathering places, mass transit vehicles and stations. Market places are ideal for the small business owner who uses this as a primary source of income as well as for individuals selling items on the street to supplement incomes. Little regulation exists and bribery and corruption account for the rest.

As noted above, the Shadow Economy is a conditions-driven environment. Another example of a shadow economy practice that developed in the absence of effective governance is the use of private suppliers for basic utility services such as electricity. During the 1990 – 1991 Persian Gulf War, allied attacks damaged the country's electrical grid and telecommunications network extensively. Peak electricity demand before the Gulf War ranged from 5,000 to 7,500 megawatts, demand which was easily met. However after the war, electrical generating capacity had been reduced to just 2,300 megawatts per day. By May 2007 electricity generating capacity has still only reached 4,000 megawatts per day and estimates claim current demand ranges from 8,500 to 9,000 megawatts.⁴³ This left a 4,500 to 5,000 megawatt deficit that had to be made up in some fashion.

A United Nations Development Program report published in 2005⁴⁴ reported that 98 percent of Iraqi households obtained electricity from the national power grid. Seventy-eight percent had indoor water supplies and 37 percent were connected to city sewage systems. The major problem however was not connection to the systems, since

⁴² Michael E. O'Hanlon and James H. Campbell, "Iraq Index: Tracking Variables of Reconstruction & Security in Post-Saddam Iraq" *The Brookings Institution* (May 10, 2007), 17.

⁴³ *Ibid.*, 37.

⁴⁴ Medhi al-Hafidh, "Iraq Living Condition Survey 2004: Volume II Analytical Report." *Central Organization for Statistics and Information Technology (COSIT) and Ministry of Planning and Development Cooperation, Baghdad, Iraq* (April 2005), 16-17.

infrastructure had traditionally been provided by the state as a public good and prices were kept low through oil rentier state subsidies. The overriding problem was that the systems had been badly neglected over 20 years of extensive use during three wars when the country's oil industry was driven almost to a standstill, and ten years of economic sanctions. So the problem was not connection to a public utility system; it is more a problem of stability and supply. While all public services are important to sustaining quality of life, the intense heat in Iraq makes electricity an important necessity for light, air conditioning and food refrigeration. As much as 31 percent of Iraqis have to supplement their power supply through private or shared generators. This figure is higher in urban areas.

The loss of basic utilities modern countries take for granted became an integral part of Iraq's Shadow Economy. Take the foregoing as an example. While the sale of electrical services is not illegal it is a utility normally provided by the state. However since the infrastructure was damaged extensively during Coalition Force bombing during the Gulf War this area was adopted as a niche market by informal businesses. In the absence of adequate infrastructure small businesses sprang up to provide this service, if only in a haphazard, potentially dangerous and unregulated fashion. Customers had little recourse; either endure the unbearable heat when the national grid was shut down or find another solution. As a more reasonable alternative, they could purchase personal electrical generators for their home, an expensive option few could afford, or pay another participant in the shadow economy, the neighborhood "Generator Man."⁴⁵

At the end of September 2006, the national power grid was still only delivering five hours of electricity per day in Baghdad. Neighborhood Generator Men advertised that they could provide 10 to 12 hours of additional electricity per day during peak times and when the power grid is shut down. This service costs approximately \$65 per month for the average middle-class family, less than the cost of owning a personal household

⁴⁵ Associated Press, "Iraq's Electricity Grid Nears Collapse," *MSNBC.com* (August 4, 2007) <http://www.msnbc.msn.com/id/12784358/> (accessed August 10, 2007), and Kirk Semple, "As Iraqi Lights Flicker, 'Generator Man' Feels the Heat," *The New York Times* (September 25, 2006) <http://www.nytimes.com/> (accessed August 10, 2007)..

generator given the rising cost of fuel.⁴⁶ In actuality, the service provided by these informal businesses is riddled with lapses, interruptions, breakdowns, etc. and is an understandable source of intense frustration for customers. Generator men are supposedly regulated by the local district councils but rates and energy supply are rarely enforced, making it an ideal Shadow Economy enterprise.

Health care deteriorated significantly following imposition of the 1991 United Nations embargo. Prior to the 1997 implementation of the Oil-for-Food Program, Iraq's food-rationing system supplied only 1300 calories per person per day, about 40 percent less than is recommended by the World Health Organization.⁴⁷ Those affected the most were children, the elderly and households headed by women. Individuals used all means at their disposal to obtain proper medical care. They exhausted personal savings, sought assistance from relatives living abroad and from influential friends. They turned to the black market and reliance on their ethnic and religious community. Children, young women, old people and the ill suffered most because of the decline in health care, water and sanitation services. As late as 1998, the Oil-for-Food Program had still not resulted in any significant improvements in these areas.⁴⁸ The lack of clean drinking water and existence of raw sewage in the city streets exposed large numbers of people to illness.

Prior to 1990, Iraq imported approximately \$500 million in drugs and medical supplies and manufactured about 25 percent of what was needed domestically. However, the Iran/Iraq War and subsequent prolonged UN economic sanctions damaged the pharmaceutical industry. Medical facilities and services and healthcare standards declined to the point where infection began to spread among patients. With medical supplies and available services in short supply, rural hospitals began referring more and

⁴⁶ Steven R. Hurst, "Water Taps Run Dry in Baghdad," *Time.com* (August 2, 2007). <http://www.time.com/time/world/article/0,8599,1649454,00.html> (accessed August 18, 2007).

⁴⁷ Christopher Foote, William Block, Keith Crane, and Simon Gray, "Economic Policy and Prospects in Iraq," *Public Policy Discussion Papers Federal Reserve Bank of Boston* (May 4, 2004).

⁴⁸ Sarah Graham-Brown, *Sanctioning Saddam: The Politics of Intervention in Iraq* (London: I. B. Tauris & CO Ltd., 1999), 180-181.

more patients to Baghdad hospitals for treatment. Unfortunately, the hospitals in Baghdad were experiencing the same shortfalls.⁴⁹

As these conditions persisted, illnesses associated with poverty and poor sanitary conditions began to emerge. Some such sicknesses included kwashiorkor and marasmus (illnesses stemming from malnutrition), tuberculosis, diarrhea and respiratory infections. Because the distribution of healthcare services and medicines were affected by government policy decisions, a black market in pharmaceutical drugs emerged and drugs used to treat conditions such as hypertension and diabetes began to be sold off by those with access, including hospital staff.⁵⁰

The Iran-Iraq War placed an inordinate amount of burdens on Iraqi women. With approximately half a million Iraqi casualties hundreds of thousands of women were widowed. Thousands of soldiers that survived the war returned home wounded, as amputees, or with psychological disorders resulting of the brutalities experienced in the trench warfare.⁵¹ It is doubtful whether Iran/Iraq and Gulf War veterans received pensions, disability or otherwise, before the Iraqi Veterans Agency was established in April 2004.⁵² It seems safe to say that little effort went into rehabilitation programs for the disabled veterans and as a consequence, many of the returning servicemen developed drinking and substance abuse problems. This only served to place additional burdens on Iraqi women responsible for holding their family together.⁵³ Already vulnerable members of a male-dominated society, women faced extensive obstacles in obtaining assistance from the Ministry of Labor and Social Affairs and the department ceased registering new candidates for assistance after 1991. In 1996, the World Food Program

⁴⁹ Sarah Graham-Brown, *Sanctioning Saddam: The Politics of Intervention in Iraq* (London: I. B. Tauris & CO Ltd., 1999), 180-181.

⁵⁰ Ibid.

⁵¹ Martin J. Martinson, "The Iran – Iraq War: Struggle Without End. *Marine Corps Command and Staff College* (April 1, 1984).

⁵² Georges Sada, "Minister of Defense Ali Allawi Announces the Establishment of the Iraqi Veterans Agency," *The Coalition Provisional Authority* (May 2, 2004). http://www.cpa-iraq.org/pressreleases/20040505_veterans.html (accessed: August 17, 2007).

⁵³ Sarah Graham-Brown, *Sanctioning Saddam: The Politics of Intervention in Iraq* (London: I. B. Tauris & CO Ltd., 1999), 180-181.

reported 450,000 registered persons who were destitute (persons with very low income, female heads of household, invalids, and elderly people without support). The organization also identified another 765,000 people from urban families in need of food aid. Most of these households were headed by females.⁵⁴ Prior to this, however the Government of Iraq requested emergency assistance in supporting vulnerable people, namely malnourished children, nursing and expectant mothers, anemic women, internally displaced persons, hospital patients, residents in social institutions and social welfare cases. At its peak sometime after 1995, the World Food Program and Food and Agriculture Organization reported providing assistance to 2.15 million Iraqi citizens. The emergency operation was phased down after the Oil-for-Food Program came on line.⁵⁵

Social conditions being what they were, Iraq experienced a trend toward extended families. Poorer families began to live in groups which again placed considerable pressure on the women of the household. Even though there were more hands to do the work, there were also more people to feed and keep healthy. These groups were among the most ardent users of Iraq's Shadow Economy.

The business of oil smuggling had been profitable since the imposition of economic sanctions in August 1990. Approximately 110,000 barrels a day was sold illegally to Jordan, Turkey and Iran. Under the Ba'ath Regime, domestic fuel products were subsidized and Iraqis could purchase gasoline and petroleum products for much less than the cost in neighboring countries. Criminal elements found this a lucrative market. According to the State Department between 10 percent and 30 percent are diverted to the black market or smuggled out of the country and sold for a profit.⁵⁶ Criminals would steal truckloads of oil and gas, smuggle it across the border to a neighboring country and sell it under the market price for a profit. Ironically, this created a shortage of fuel in Iraq

⁵⁴ Sarah Graham-Brown, *Sanctioning Saddam: The Politics of Intervention in Iraq* (London: I. B. Tauris & CO Ltd., 1999), 180-181.

⁵⁵ World Food Programme, "Assistance to Malnourished Children and Their Parents, Patients in Hospitals and Residents in Social Institutions," *Protracted Relief and Recovery Operation - 6085.00* (December 21, 1998).

⁵⁶ Joseph A. Christoff, "Rebuilding Iraq: Serious Challenges Impair Efforts to Restore Iraq's Oil Sector and Enact Hydrocarbon Legislation." *Government Accountability Office*. GAO-07-1107T (July 18, 2007).

and oil and gas would have to be imported and further subsidized to make up for the shortfall. Oil smuggling cost the Iraqi government millions of dollars in lost revenue in 2006 alone.⁵⁷

Selling Iraqi goods illegally in neighboring countries extended to more than oil. As inflation increased sharply and the Iraqi Dinar lost value to other currencies, taxi and bus drivers routinely transported goods purchased at home to sell them for a profit in Amman, Jordan.

So the trend continued. The Shadow Economy proved dynamic and flexible under a stoic, unrelenting Ba'athist Regime until the Coalition Force invasion of 2003. Then the violence that erupted led its transition into a Combat Economy.

3. Iraq's Combat Economy

Insurgents. Iraq's Shadow Economy underwent a significant transition almost immediately following the fall of Saddam Hussein's regime. Crowds of Iraqi citizens poured into the streets and began cheering and celebrating. At first all seemed well, then as the euphoria took hold, the crowds went wild, tearing down posters of Saddam Hussein and bringing down his statutes and then the looting began. With barely a pause for breath this energy redirected itself into an insurgency. This is an obvious oversimplification but the events seemed to be seamless.

Iraq had, however, been experiencing restive turmoil much earlier beginning with the uprisings that took place after the army's defeat in Kuwait.⁵⁸ Even among Saddam's inner circles (family, tribes and clans), there were signs of discontent. The Republican Guard was repeatedly deployed to the Kurdish border for security operations during the four-year period between 1992 and 1996 and other Iraqi forces⁵⁹ were dispatched in the south during the same period. Iraqi secret police units were very active arresting

⁵⁷ Joseph A. Christoff, "Rebuilding Iraq: Serious Challenges Impair Efforts to Restore Iraq's Oil Sector and Enact Hydrocarbon Legislation." *Government Accountability Office*. GAO-07-1107T (July 18, 2007).

⁵⁸ Abbas Kadhim, "Civil-Military Relations in Iraq (1921-2006): An Introductory Survey." *Strategic Insights* V 5 (May 2006).

⁵⁹ Ibid.

dissidents and spreading fear as a means of maintaining control.⁶⁰ An assassination attempt in 1996 on Saddam Hussein's son, Uday, left him with eight bullet wounds to his left side which nearly killed him, resulted in a stroke and seizures.⁶¹ It is inconclusive whether those responsible were discovered. After the Gulf War the Iraqi Army was reduced in size from almost a million soldiers to less than 400,000. Pay and benefits for the remaining active forces did not provide sufficient wealth under 1993 economic conditions. The desertion rate increased as did government reprisals. So while the widespread insurgency that grabbed the world's attention did not commence until 2003, it is reasonably safe to say that the Combat Economy simmered just under the surface for almost ten years before.

To put the affect of the insurgency on the Combat Economy, it is helpful to understand the professionalism of the insurgents. While some of the insurgent attacks that took place in the summer of 2003 were carried out by professional groups, the majority were embarked upon by ordinary people hired by former regime loyalists to carry out hit and run attacks. The amateurs were killed off by the Coalition Forces easily while the insurgents with prior military training and experience survived. Then the fall of 2003 saw evidence of an increase in the number of former Iraqi Army soldiers among insurgents. They did not sympathize with the fallen Ba'athist regime but since the Iraqi Army was disbanded in May 2003, they had lost their jobs, privileges and standing within the community. Their participation in attacks against Coalition forces could be detected in the professional preparation and execution of ambushes and attacks carried out in Tikrit and Ramadi.⁶² The number of attacks on Coalition Forces, acts of terrorism on Iraqi citizens, i.e. kidnappings, car bombings, political assassinations, and sectarian killings, etc. grew in number as the number of insurgents multiplied. In November 2003 it was estimated that insurgents in Iraq numbered approximately 5000. By December the

⁶⁰ Sarah Graham-Brown, *Sanctioning Saddam: The Politics of Intervention in Ira*. (London: I. B. Tauris & CO Ltd., 1999), 192-193.

⁶¹ Brian Bennett and Michael Weisskopf, "The Sum of Two Evils." *TimeMagazine*. (June 2, 2003). <http://www.time.com/time/magazine/article/0,9171,1004927,00.html> (accessed March 19, 2007).

⁶² Ahmed S. Hashim, *Insurgency and Counter-Insurgency in Iraq* (Ithaca, NY: Cornell Press University, 2006).

following year that estimate had quadrupled. By October 2006 militia forces added and additional 10,000 bringing the estimate to approximately 30,000. By March 2007, the Brookings Institute reported that the figure had jumped significantly, to around 70,000 Sunni insurgents.⁶³

Insurgent groups are organized into hierarchical and decentralized structures, or a mix of the two. Hierarchical organizations provide leadership and a defined chain of command much like a typical U.S. military organization. Units within this structure can be given unique missions, i.e. to fight, gather intelligence, recruit or supply money and weapons. The decentralized organizational structure was harder to draw. It was less clear who the leaders were and in many cases resulted in a sprawling organization made up of cells, family, neighbors loosely tied and intent on disrupting reconstruction initiatives.⁶⁴ Decentralized insurgent organizations have similar specialized cells including those for combat, procurement, communications, bomb-making, etc. One distinctive characteristic for decentralized groups, however is that knowledge of the organizational structure is compartmentalized for operational security.

Operating an insurgency requires light weapons, ammunition, safe houses, vehicles, information, special skills, and training facilities. Prior to his fall, Saddam Hussein ordered distributed thousands of tons of arms, ammunition, equipment and millions of dollars throughout the country to fuel an insurgency. These were stored in every conceivable facility including mosques, schools and hospitals. Disbanding the armed forces left three-quarters to one million tons of weapons and ammunition unguarded in ammunition storage facilities. Therefore weapons and ammunition are widely available through theft or purchase throughout Iraq. By the spring of 2005, Coalition forces had located and destroyed 10,000 arms caches.

The Iraqi insurgency relies on three main sources of finance; money caches, external and internal sources. Former Ba'ath Party loyalists hid money around the

⁶³ Michael O'Hanlon and Jason H. Campbell, "Iraq Index: Tracking Variables of Reconstruction & Security in Post-Saddam Iraq," *The Brookings Institution* (May 10, 2007).

⁶⁴ Ahmed S. Hashim, *Insurgency and Counter-Insurgency in Iraq* (Ithaca, NY: Cornell Press University, 2006), 152-153.

country prior to its downfall. Even though many of these caches have been discovered insurgents still appear to have access to the funds they need to operate. Saddam Hussein's cousins in Syria and Jordan reportedly had access to tens of millions of dollars, profits from smuggled oil and military equipment that was used to purchase weapons and hire fighters. Donations also come from wealthy individuals in construction, contracting and the commercial sectors in Anbar Province.⁶⁵

Organized Crime. The primary motive for organized crime syndicates is money. A symbiotic relationship developed in Iraq between insurgents and elements of organized crime as witnessed by acts of violence perpetrated alongside or as part of insurgent actions. Iraq with its weak governance, particularly in the areas of Political Stability and Absence of Violence, Rule of Law and Control of Corruption proved ideal for organized crime activities. Linkages between the two groups were even better where individuals were members of both groups. Insurgents continue to rely on organized crime to extort, steal or kidnap to raise money.

Kidnapping was a lucrative means of making money. When kidnapping figures began to be maintained in January 2004, two Iraqi citizens were being kidnapped every day in Baghdad. This number increased to ten per day by the end of the year. By December 2005, as many as thirty Iraqi citizens were reported kidnapped every day throughout the country. And by March 2006 the Brookings Institute estimated that between thirty and forty Iraqis were being kidnapped every day throughout the country. It was further estimated that the average ransom was \$30,000, quite a profit for a few days' worth of coordination and effort.⁶⁶ Some victims are returned to their families while others are kidnapped and sold to insurgents. Execution is also common when negotiations go awry; in some cases it is the intended outcome. This practice serves the dual purpose of earning a profit for insurgent and criminal and furthering the terrorist objectives of the insurgents.

⁶⁵ Ahmed S. Hashim, *Insurgency and Counter-Insurgency in Iraq* (Ithaca, NY: Cornell Press University, 2006), 168.

⁶⁶ Michael O'Hanlon and Jason H. Campbell, "Iraq Index: Tracking Variables of Reconstruction & Security in Post-Saddam Iraq," *The Brookings Institution* (May 10, 2007), 20.

Targeting Critical Infrastructure. Power stations, natural-gas plants, oil installations and oil pipelines have been used as a resource to support the Combat Economy. Looters vandalized infrastructure for something of value to use or sell. Organized criminals target the infrastructure for equipment, spare parts they can sell and for petroleum products they can smuggle for resale. Large amounts of fuel were being smuggled because of the lower oil prices in Iraq. Iraq is crisscrossed by 4350 miles of oil and gas pipelines⁶⁷, some of which are above ground and easy to reach. (See Figure 2). It also has an 11,000 mile-long power grid. The pipelines are critical for Iraqi citizens as it delivers fuel for transportation, for electrical generator plants, for electric pumps in water and sewage treatment plants and kerosene for cooking. Some smugglers drill into the pipes between refinery and the shipping terminals. Others purchase fuel in Iraq, filling trucks and cars outfitted with extra fuel tanks and then sell the fuel in Jordan where it can sometimes be sold at ten times the cost. Politically-motivated insurgents attack critical infrastructure to impede reconstruction efforts. How important infrastructure targets are to these groups is demonstrated by the number of attacks upon them. Between June 2003 and March 26, 2007, Iraqi oil and gas pipelines, installations and personnel were attacked 402 times. In 2005, the Iraqi Oil Ministry's response to this situation consisted of monitoring efforts at gas stations, restricting the number of gas cans that could be filled, to three, and raising fuel prices for fuel put into gas cans. The domestic pipelines were discontinued in favor of tanker trucks operated by Sunni Arab drivers to ferry the fuel from oil refineries in Baiji and Basra.⁶⁸ The U.S. military set up Task Force Shield to guard Iraq's energy infrastructure, particularly the Kirkuk-Ceyhan oil pipeline. One of the key elements of the Third and Fourth Reviews of the International Monetary Fund's Stand-by Agreement with the Government of Iraq for 2007 is the increase of domestic

⁶⁷ Energy Information Administration, "Iraq Oil," <http://www.eia.doe.gov/emeu/cabs> (accessed May 26, 2007).

⁶⁸ Vivian C. Jones, "Iraq's Trade with the World," *CRS Report for Congress* RL 32025 (March 25, 2005), 14.

fuel prices. The government will eliminate subsidies for imported premium gasoline and other fuel products. Private sector imports will be encouraged.⁶⁹

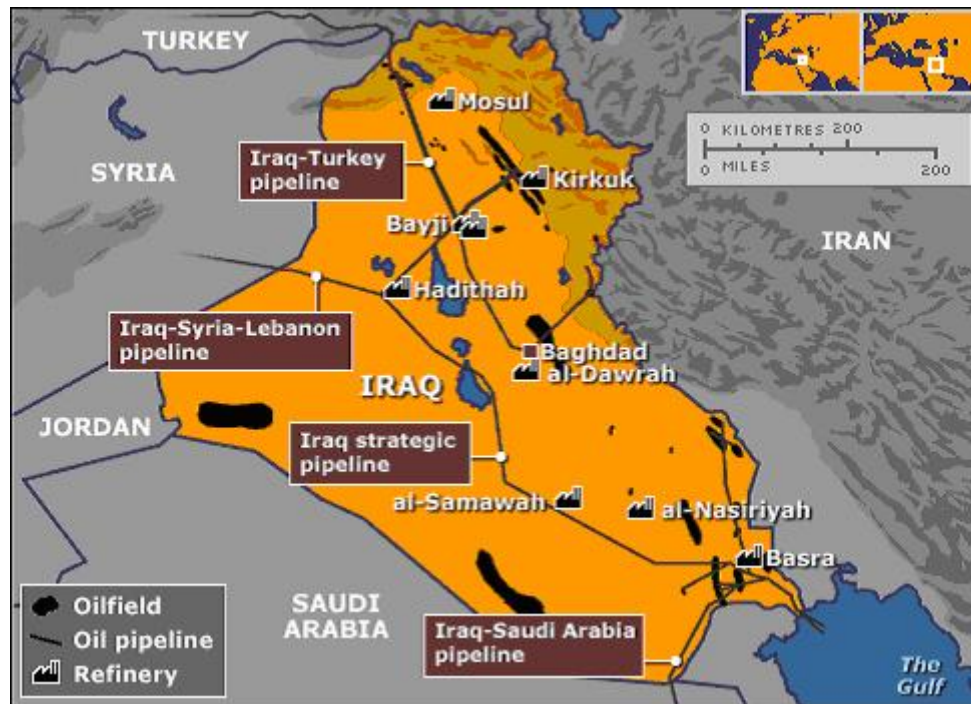


Figure 2. Iraq Oil Pipelines

Corruption. The practice of corruption was well ingrained in Saddam Hussein's regime. It continues to undermine Coalition and the Iraqi Government efforts to make end roads against the insurgency still four years after his removal. Gaining positive control of the country is made more difficult by the existence of high unemployment (25-40% in December 2006), massive amounts of guns and ammunition for the insurgency, the increasing gap between the poor and wealthy, and an ineffectual government.⁷⁰ Corruption is a sickly condition that permeates and drags down the Iraqi culture much as

⁶⁹ International Monetary Fund, "Third and Fourth Reviews Under the Stand-By Arrangement, Financing Assurances Review, and Requests for Extension of the Arrangement and for Waiver of Nonobservance of a Performance Criterion," *IMF Country Report* No. 07/115 (March 2007), 8.

⁷⁰ Robert Looney, "Reconstruction and Peace Building Under Extreme Adversity: The Problem of Pervasive Corruption in Iraq," Draft (July 22, 2007).

alcohol addiction, drug abuse and domestic violence does in cultures around the world. It is especially debilitating amidst the rampant violence embracing the country since 2003. The track record for corruption within Iraqi society is quite extensive. See Figure 3 for an illustration representing income from illegal sources. Following are some examples that occurred both under Saddam Hussein's rule and since his removal.

Members of the business community cited an interesting example. Saddam Hussein would select and foster the growth of certain businesses ensuring they received preferential treatment and when he deemed the time was right, would seize the firm and confiscate its bank accounts and assets. The owner would, "disappear." This was reportedly, "Saddam's fattening of the lamb before the slaughter."⁷¹

Business owners faced unusual risks. Obtaining a license to start a new business could take up to a year and subject the prospective owner to risk of legal charges as each applicant was investigated to see if they had undesirable affiliations. Business owners would rather bribe government inspectors than risk the scrutiny of the Ba'th Party to obtain a license legally. Because of the extensive surveillance, threat by thugs working for the government and organized crime, businesses were hesitant about marketing their services on a large scale. If they were seen to be exceptionally successful or profitable, the regime and/or criminals would press the owner for a share of the takings. If the owner failed to cooperate, he was killed and his business was taken over.

The United Nations Security Council created the Oil for Food Program in 1995 to allow Iraq to export \$2 billion worth of food every six months.⁷² The six-month ceilings were raised to \$5.3 billion in 1998 and removed completely in 1999. The only stipulation remained that Iraq comply with U.N. reviews of the sales receipts and expenditures of the profits. Iraq turned the arrangement in their favor by adding a surcharge of 30-50 cents per barrel on buyers and used the illegal kickbacks to make purchases outside of the purview of the U.N. committees. The General Accounting Office estimated that Iraq

⁷¹ Christopher Foote, William Block, Keith Crane, and Simon Gray, "Economic Policy and Prospects in Iraq," *Public Policy Discussion Papers, Federal Reserve Bank of Boston* No. 04-1 (May 4, 2004).

⁷² Jonathan E. Sanford, "Iraq's Economy: Past, Present, Future," *CRS Report for Congress* RL 31944 (June 3, 2003), 34.

took in almost \$7 billion in the four years from 1997 to 2001. Saddam Hussein was able to turn these illegal profits into a program for building new palaces at the expense of the Iraqi citizens. Neighboring countries; Syria, Turkey, and Jordan constituted major illicit oil trading partners⁷³

**Figure 1. Iraqi Illicit Revenue Sources 1990-2003 (US\$)
Duelfer Report Estimates**

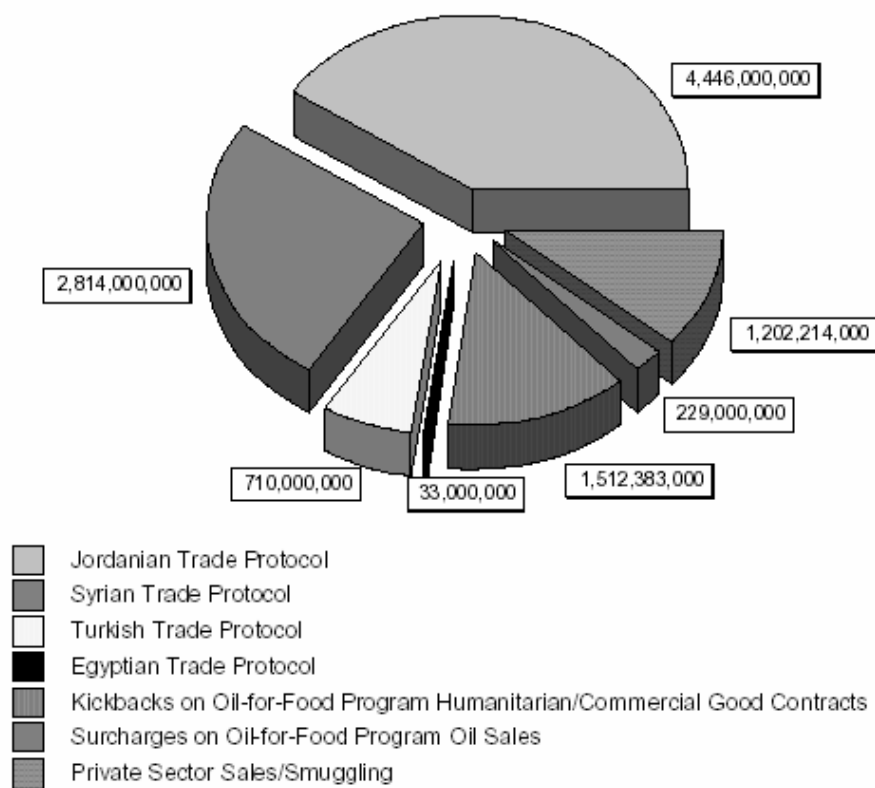


Figure 3. Illicit Revenue Sources

According to the Baker-Hamilton Report, experts estimated that 150,000 to 200,000 as much as half a million barrels of oil were stolen every day across the country.

⁷³ Jonathan E. Sanford, "Iraq's Economy: Past, Present, Future," *CRS Report for Congress* RL 31944 (June 3, 2003), 34-35.

Subsidies cost Iraqi approximately \$11 billion annually. The reduced purchase price resulted in shortages which drive consumers to the bustling black market.⁷⁴ By 2004, oil smuggling had increased to the point where it became difficult for Iraqis to purchase the fuels they needed. Queues remain long and gas stations are controlled alternately by a wide cast of characters including; gas station owners, local militia, criminals, and even soldiers from the Iraqi Army. Everyone except for the select few can expect long delays (hours, sometimes days) to get to the pumps.

During the period of UN sanctions on Iraq, Fallujah (City of Mosques) became a focal point of the smuggling trade and regular commerce with Syria and Jordan. Trade consisted mainly of consumer goods, construction materials and equipment. The trade involved an alliance between the tribes and members of the Ba'th regime's security services who lived in the area and were generally related to the tribes. The security services facilitated the process of smuggling, while the tribes provided access to their kin in Syria and Jordan. Once sanctions were in full swing, the regime promoted these smuggling operations. Officials were after a share in the profits because their own salaries had been reduced.⁷⁵ So a select few, and the city of Fallujah, profited.

The fact that Coalition forces put a stop to this smuggling route without providing an alternative means of generating income proved an irritant. Insurgent attacks on Coalition targets gained momentum slowly but steadily. By late summer 2003 the Jordanian Embassy was bombed (7 August) and the UN headquarters at the Canal Hotel followed quickly on 19 August. The insurgents began targeting oil pipelines and water mains as well any individuals who participated in the reconstruction process.⁷⁶ As

⁷⁴James A Baker III and Lee H Hamilton, *The Iraq Study Group Report-The Way Forward-A New Approach* (New York: Vintage Books, 2006).

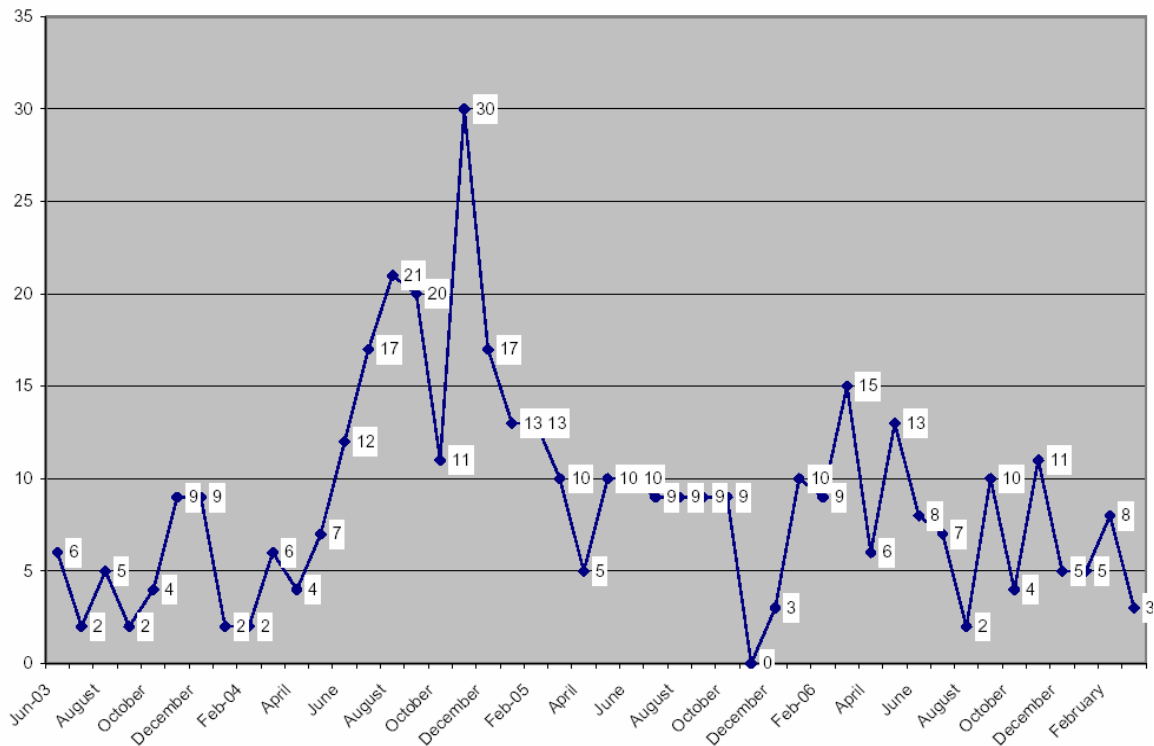
⁷⁵ Ahmed S. Hashim, *Insurgency and Counter-Insurgency in Iraq* (Ithaca, NY: Cornell University Press, 2006), 25-26.

⁷⁶ *Ibid.*, 31-32.

demonstrated in Figure 4 between June 2003 and March 26, 2007, the Brookings Institute recorded 402 separate attacks on Iraqi oil and gas pipelines, installations and personnel.⁷⁷

On 28 June 2004, Hazim al-Sha'lan was appointed as the Iraqi Ministry of Defense. A year later he and twenty-six others were accused of embezzling more than a billion dollars in U.S. procurement funds.⁷⁸

ATTACKS ON IRAQI OIL AND GAS PIPELINES, INSTALLATIONS & PERSONNEL⁴³



Total through March 26, 2007: 402

Figure 4. Gas and Oil Pipeline Attacks 2003 to 2007.

⁷⁷ Michael E. O'Hanlon and James H. Campbell, "Iraq Index: Tracking Variables of Reconstruction & Security in Post-Saddam Iraq." *The Brookings Institution* (May 10, 2007), 26, and Iraq Oil Pipeline Watch. "Institute for Analysis of Global Security in collaboration with Oil (IAGS) and Gas Industry Terrorism Monitor (OGI-TM). <http://www.iags.org/iraqpipelinewatch.htm> (accessed August 17, 2007).

⁷⁸ Abbas Kadhimi, "Civil-Military Relations in Iraq (1921-2006): An Introductory Survey," *Strategic Insights* V 5 (May 2006) and Mohamed al-Shaf'ei, "Al-Sha'lan: I Have Filed a Slander Lawsuit in London Against Three Iraqi Officials, Hadi al-Ameri, Ali al-Lami, Ali Allawi," *Iraq Updates*. (September 29, 2005). http://www.iraquupdates.com/p_articles.php/article/2900 (accessed August 18, 2007).

Transparency International Corporation's Annual Report for 2006 rated Iraq as the most corrupt of 163 countries, only slightly ahead of Myanmar and Haiti.⁷⁹ (See Figure 5). This standing represents a disturbing, but full understandable downward slide since 2004 when Iraq was ranked 129th out of 145 nations worldwide. Neither the CPA nor the new Iraqi Government has been able to curb corruption, the insurgency or even agree on certain key issues like distribution of oil wealth or the need to put down militias. The outcome of the debate on hydrocarbon sector and revenue sharing legislation proposed in June 2007 remains to be seen.⁸⁰

⁷⁹ Transparency International, *Transparency International Corporation's Annual Report* (JM Stefpko Printing House, 2006) www.transparency.org (accessed June 10, 2007).

⁸⁰ Christopher M. Blanchard, "Iraq: Oil and Gas Legislation, Revenue Sharing, and U.S. Policy", *CRS Report for Congress*, RL 34064, (26 June 2007).

CORRUPTION PERCEPTIONS INDEX 2006

Rank	Country	Score	Rank	Country	Score	Rank	Country	Score
1	Finland	9,6	55	Namibia	4,1	111	Albania	2,6
1	Iceland	9,6	57	Bulgaria	4,0	111	Guatemala	2,6
1	New Zealand	9,6	57	El Salvador	4,0	111	Kazakhstan	2,6
4	Denmark	9,5	59	Colombia	3,9	111	Laos	2,6
5	Singapore	9,4	60	Turkey	3,8	111	Nicaragua	2,6
6	Sweden	9,2	61	Jamaica	3,7	111	Paraguay	2,6
7	Switzerland	9,1	61	Poland	3,7	111	Timor-Leste	2,6
8	Norway	8,8	63	Lebanon	3,6	111	Vietnam	2,6
9	Australia	8,7	63	Seychelles	3,6	111	Yemen	2,6
9	Netherlands	8,7	63	Thailand	3,6	111	Zambia	2,6
11	Austria	8,6	66	Belize	3,5	121	Benin	2,5
11	Luxembourg	8,6	66	Cuba	3,5	121	Gambia	2,5
11	United Kingdom	8,6	66	Grenada	3,5	121	Guyana	2,5
14	Canada	8,5	69	Croatia	3,4	121	Honduras	2,5
15	Hong Kong	8,3	70	Brazil	3,3	121	Nepal	2,5
16	Germany	8,0	70	China	3,3	121	Philippines	2,5
17	Japan	7,6	70	Egypt	3,3	121	Russia	2,5
18	France	7,4	70	Ghana	3,3	121	Rwanda	2,5
18	Ireland	7,4	70	India	3,3	121	Swaziland	2,5
20	Belgium	7,3	70	Mexico	3,3	130	Azerbaijan	2,4
20	Chile	7,3	70	Peru	3,3	130	Burundi	2,4
20	USA	7,3	70	Saudi Arabia	3,3	130	Central African Republic	2,4
23	Spain	6,8	70	Senegal	3,3	130	Ethiopia	2,4
24	Barbados	6,7	79	Burkina Faso	3,2	130	Indonesia	2,4
24	Estonia	6,7	79	Lesotho	3,2	130	Papua New Guinea	2,4
26	Macao	6,6	79	Moldova	3,2	130	Togo	2,4
26	Portugal	6,6	79	Morocco	3,2	130	Zimbabwe	2,4
28	Malta	6,4	79	Trinidad and Tobago	3,2	138	Cameroon	2,3
28	Slovenia	6,4	84	Algeria	3,1	138	Ecuador	2,3
28	Uruguay	6,4	84	Madagascar	3,1	138	Niger	2,3
31	United Arab Emirates	6,2	84	Mauritania	3,1	138	Venezuela	2,3
32	Bhutan	6,0	84	Panama	3,1	142	Angola	2,2
32	Qatar	6,0	84	Romania	3,1	142	Congo, Republic	2,2
34	Israel	5,9	84	Sri Lanka	3,1	142	Kenya	2,2
34	Taiwan	5,9	90	Gabon	3,0	142	Kyrgyzstan	2,2
36	Bahrain	5,7	90	Serbia	3,0	142	Nigeria	2,2
37	Botswana	5,6	90	Suriname	3,0	142	Pakistan	2,2
37	Cyprus	5,6	93	Argentina	2,9	142	Sierra Leone	2,2
39	Oman	5,4	93	Armenia	2,9	142	Tajikistan	2,2
40	Jordan	5,3	93	Bosnia and Herzegovina	2,9	142	Turkmenistan	2,2
41	Hungary	5,2	93	Eritrea	2,9	151	Belarus	2,1
42	Mauritius	5,1	93	Syria	2,9	151	Cambodia	2,1
42	South Korea	5,1	93	Tanzania	2,9	151	Cote d'Ivoire	2,1
44	Malaysia	5,0	99	Dominican Republic	2,8	151	Equatorial Guinea	2,1
45	Italy	4,9	99	Georgia	2,8	151	Uzbekistan	2,1
46	Czech Republic	4,8	99	Mali	2,8	156	Bangladesh	2,0
46	Kuwait	4,8	99	Mongolia	2,8	156	Chad	2,0
46	Lithuania	4,8	99	Mozambique	2,8	156	Congo, Dem. Republic	2,0
49	Latvia	4,7	99	Ukraine	2,8	156	Sudan	2,0
49	Slovakia	4,7	105	Bolivia	2,7	160	Guinea	1,9
51	South Africa	4,6	105	Iran	2,7	160	Iraq	1,9
51	Tunisia	4,6	105	Libya	2,7	160	Myanmar	1,9
53	Dominica	4,5	105	Macedonia	2,7	163	Haiti	1,8
54	Greece	4,4	105	Malawi	2,7			
55	Costa Rica	4,1	105	Uganda	2,7			

The score relates to perceptions of the degree of corruption as seen by business people and country analysts, and ranges between 10 (highly clean) and 0 (highly corrupt). For more information, please see: www.transparency.org/policy_research/surveys_indices/cpi/2006

Figure 5. Transparency International Index

This year's report highlighted the role of legal and financial facilitators who served as enablers of corruption by allowing the proceeds of corruption to be moved, laundered, stored and invested.⁸¹

Public ministries of the Iraqi Government that should have already taken a leading role in reconstruction have made little headway. Deeply divided along tribal, ethnic, religious and political lines, progress is difficult. There is a noted hesitation on the part of the Government of Iraq about taking over projects started by reconstruction teams or ensuring routine maintenance is performed on completed projects. The Special Inspector General for Iraq Reconstruction (SIGIR) cited the following examples in his July 2007 Report to Congress.⁸²

- Baghdad International Airport. \$11.8 million spent on new electrical generators but \$8.6 million worth of the project is no longer operating.
- New water purification system in Erbil maternity hospital not operating. Medical waste incinerator padlocked, medical waste disposed of in sewage system. Newly installed oxygen distribution system is not being used due to lack of training.
- Generators missing from Camp Ur military base. Three modular buildings costing \$1.8 million missing.
- Renovated barracks for enlisted soldiers already damaged and in need of repair. Facility handed over to Iraqi Army just twelve months ago.

These latest problems raise concern over the Iraqi government's ability to carry forward the reconstruction effort. Contributing factors include improperly trained staff and a large number of unskilled workers. Political rivalries and sectarian loyalties make it difficult for the ministries to meet on common ground for the common good. Some ministries such as the Ministry of Interior, Agriculture, Health, Transportation and

⁸¹ Transparency International Annual Report 2006. Transparency International. JM Stefkó Printing House.

⁸² Special Inspector General for Iraq Reconstruction, Moving Beyond the IRRF (Washington, SIGIR, April 30, 2007).

Tourism are led by individuals with strong ties to political parties who in turn are strongly opposed to U.S. goals. Their combative positions are less than helpful.⁸³

Corrupt practices and the lack of unity (or progress) within the Iraqi Government do little to inspire the confidence of the international community, many who have expressed an interest in an International Compact with Iraq. Aside from the raging violence throughout much of the country, corruption is viewed as the most significant obstacle to reconstruction. The SIGIR reported that Iraq has been losing \$4 billion to corruption every year since 2003 and there are now about 1,400 active criminal corruption cases. Paying bribes for services has been a standard practice for several years and there is no change in sight.

Corruption has a deleterious affect on Iraqi social capital which refers to networks of relationships that bind people together.⁸⁴ In considering the measures that will be required to rebuild confidence in the institutions of Iraq a key element is the notion of trust. Trust motivates contact with others and presents opportunities for the exchange of goods and services. Many Iraqi citizens have never seen the inside of a bank. The banking institution is antiquated and still relies on cash transactions. Iraqis are more likely to transfer money using the hawala system of money transfer which lends itself to providing an untraceable source of funds.⁸⁵ Funds transferred using the hawala method are not regulated and thus are ideal for illegitimate purposes.

4. Conclusions

Part of Saddam Hussein's legacy in Iraq is a crippled economy and corrupted judicial and legal institutions. He eliminated extended trust in institutions that were already in place when he rose to power. The Ba'ath Party weakened process-based trust by spreading corruption and violence and channeled almost all financial transactions into

⁸³ Robert Looney, "Reconstruction and Peace Building Under Extreme Adversity: The Problem of Pervasive Corruption in Iraq," Draft (July 22, 2007).

⁸⁴ Francis Fukuyama, "Social Capital and Civil Society," *The Institute of Public Policy George Mason University* (October 1, 1999).

⁸⁵ Robert Looney, "Hawala: The Terrorist's Informal Financial Mechanism," *Middle East Policy* X 1 (Spring 2003).

the ascribed trust category. Their actions were not deliberate in all cases but the poor state of the economy with its expansive informal sector was a consequence of the steps they took to remain in power.

In one respect empowering local tribes to maintain order in their provinces was a positive event. It garnered support and cooperation for the regime because of the trust and confidence tribal leaders received. It also allowed tribal leaders to maintain credence and respectability and more materialistic and practical items such as arms and ammunition, vehicles and logistical support. The arrangement was less than ideal as the distribution of power among all of Iraq's tribes was not equal. Saddam Hussein helped foster a shadow economy by pitting tribes against each other, leading the country into a protracted war that resulted in the destruction of important infrastructure. He then used funds, rations, employment, utilities and business opportunities as a way of buying loyalty. The shadow economy that emerged only grew in strength as the years wore on and tribal groups gained more control over their respective areas. It transitioned smoothly into a sanctuary in which insurgents and criminals could operate freely after the 2003 invasion. As demand for fighters, arms, ammunition and funding increased so did involvement by insurgents and organized crime in the shadow economy.

The shadow economy proved a resilient and resourceful entity in Iraq after the Ba'athist Party was removed from power.⁸⁶

- It prospered under failed attempts to implement neo-liberal economics.
- Shortages of essential utilities and increasing danger reinforced dependence on tribal and extended family associations.
- Widespread corruption accelerated participation in the shadow economy.
- Criminal activity increased considerably, i.e. kidnapping, looting, drugs, smuggling and attacks on coalition forces.

⁸⁶Robert Looney, "Reconstruction and Peace Building Under Extreme Adversity: The Problem of Pervasive Corruption in Iraq," Draft (July 22, 2007).

- In more lawless areas the shadow economy was the only real option available.

Four years of comprehensive reconstruction efforts have resulted in some gains toward restoring essential infrastructure and creating institutions that will eventually help formalize the economy but the road has been filled with trial and tribulation. The country had almost collapsed into an all out civil war then appeared to precariously right itself. It is from this state that the Iraqi Government must lead. Corrective measures undertaken over the past four years will be analyzed in the following section.

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III. THE ROAD TO ECONOMIC RECOVERY

A. INTRODUCTION

The Shadow Economy that was discovered by the Coalition Provisional Authority in March 2003, inherited by the Iraqi Interim Government in June 2004, and then the new Iraqi Government in May 2006, had been steadily institutionalized over the course of several decades. Its existence, coupled with the lack of a dominant formal economy and reinforced by black market forces, organized crime, ingrained corruption and sectarian violence shackled the country and has made tough going for the government as it tries to regain control.

Since a healthy, functioning formal economy is a key ingredient of a successful state, it is necessary to understand what needs be done to adjust the workings of the economy in Iraq. This section will focus on the best methods for the Iraqi government to take positive control and establish a functioning, productive formal economy.

The economic situation in Iraq, long in the making, is dire enough that the 2007 Index of Economic Freedom cannot grade Iraq singly as a country or within the region because of insufficient data. The Ba'athist Regime managed a centrally controlled economy and metrics used to measure economic freedoms were either not maintained or were kept secret. Figures that were available tended to be skewed or inaccurate for the purposes of the study. Income tax has been set at 15% which is unrealistic for the majority of Iraqis who are living at a subsistence level. Foreign investment opportunities have been opened up, and banking laws liberalized. However, economic recovery is still hindered by continued insurgency and instability.⁸⁷ Iraq's banking system is still in the infant stage compared to other countries. Further, the government has still not begun to distribute oil profits to Iraqi citizens as directed in the constitution. Factors such as the

⁸⁷ Tim Kane, Kim R. Holmes, Mary A. O'Grady with Ana I. Eiras, Anthony B. Kim, Daniella Markheim, Andrew L. Peek, and Brett D. Schaefer, "2007 Index of Economic Freedom." *The Heritage Foundation and Dow Jones & Company* (2007).

lack of a trusted international banking network, comparatively high tax rates, meager income and corruption only serve to fuel the shadow economy.

B. DISCUSSION OF POLICY INITIATIVES

1. National Strategy for Victory in Iraq and the New Way Forward⁸⁸

The U.S. Government National Strategy for Victory in Iraq laid out these political, security and economic tracks for success.

- **Political Objectives.** To help the Iraqi people form a democratic government by, a) isolating hardened enemy elements and working with groups that support a peaceful political process, b) engaging the undecided and those under the influence of the enemy, but desiring change, and c) build national institutions Iraqi citizens can have confidence in, that will help restore their place on the world stage.
- **Security Objectives.** Establish effective Rule of Law by, a) clearing and controlling and capturing or killing the enemy, b) help the Iraqi government hold freed areas, and c) build Iraqi Security Forces and the capacity of local institutions.
- **Economic Objectives.** Help establish foundations for a sound economy by, a) restoring neglected infrastructure, b) reforming an economy shaped by war, dictatorship and sanctions, and c) build capacity to maintain infrastructure, participate in international economic community and improve welfare of society.

The 2005 National Strategy for Victory in Iraq was modified in January 2007 to delineate more clearly the responsibility of the Iraqi government in rebuilding their country. It also provided more defined roles for the Iraqi government and coalition forces. These measures were taken due to a lack of measurable progress and a lack of

⁸⁸ National Security Council, *National Strategy for Victory in Iraq* (November 2005), and Fact Sheet: “The New Way Forward.” (January 10, 2007) www.whitehouse.gov/infocus/iraq/ (accessed April 22, 2007).

cohesion within the Iraqi government, and growing dissatisfaction among the American public with the situation in Iraq and the number of American casualties. President Bush's updated strategy was entitled "The New Way Forward in Iraq" and grounded in six fundamental elements:

- Let the Iraqis lead
- Help Iraqis protect their citizens
- Isolate extremists
- Make room for political progress
- Diversify political and economic efforts, and
- Apply a regional approach to the national strategy in Iraq.

The revised strategy appeared more of a contract between the Iraqi government and the Coalition with responsibilities spelled out for each party and an area for shared responsibilities. The areas addressed were again, security, political, and economic, plus an additional topic – regional.

- Security.
 - The Iraqi government will publicly lay responsibility on all parties for stopping sectarian violence. Deliver Iraqi forces where needed, particularly in Baghdad. Provide the nation even-handed security. Develop a demobilization plan for militias.
 - The Coalition will continue to enable accelerated transition and political progress. Provide additional military and civilian resources. Help local tribes fight Al Qaeda in the Anbar Province. Support embedded program.
 - Both organizations will continue counter-terror operations. Accelerate the shift toward Iraqi responsibility and ownership. Increase the size and effectiveness of the Iraqi security force. Establish a National Operations Center, National Counterterrorism

Force, and National Strike Force. Increase transparency, accountability and transform the National Police.

- Political.
 - The Iraqi government will reform its cabinet for more even-handedness. Act on promised reconciliation initiatives. Give Coalition and ISF authority to pursue ALL extremists. All Iraqi leaders will commit to supporting reconciliation.
 - Coalition forces will support political moderates, support the national compact and reconciliation. Increase political inclusion by expanding PRT footprint, and open space for moderates beginning in Baghdad and Anbar.
 - Both organizations will establish a forum where all parties are clear on expectations and responsibilities. Strengthen the rule of law and fight corruption. Build on security gains. Make Iraqi institutions even-handed.
- Economic
 - The Iraqi government will deliver economic resources and provide essential services to all areas and communities. Enact hydrocarbon law. Capitalize and execute job-producing programs. Share in responsibility for creating jobs with long-term sustainable programs. Support economic efforts in secure areas.
 - Coalition forces will continue to help Iraqis build capacity in vital areas of the government. Focus more capacity-building efforts outside the Green Zone. Integrate economic strategic and military effort to a greater extent.

- Regional
 - The Iraqi government will engage Arab states. Spearhead a regional forum for the purpose of giving and obtaining support. Counter negative foreign activity in Iraq. Increase efforts to counter the PKK.
 - Coalition forces will intensify efforts against Iranian and Syrian influence in Iraq. Increase military presence in the region. Strengthen defense ties with partner states. Encourage Arab state support for Iraq. Help manage Iraq/Turkey relations. Continue to seek regional support for the War on Terror.
 - Both organizations will focus on the International Compact and retain active U. N. engagement in Iraq.

The National Strategy for Victory in Iraq was formulated to target areas important for restoring peace and stability, governance, security and economic growth. However, execution was problematic at best and complicated immensely by insurgent and terrorist violence. Modification of the strategic plan was necessary because progress in Iraq was unsatisfactory. Under these conditions, the Government of Iraq was fragmented, with groups either unwilling or unable to compromise on important issues facing the country. The government found it difficult to impose its will and coalition forces found it similarly difficult to provide adequate security for the country while training an Iraqi Army and National Police force. Corrupt practices that were once accepted in the Ba'athist regime emerged and began to take hold in the new government and were well ingrained in the populous. This made progress a more or less a slow endeavor. In addition, the government seemed to turn a blind eye on militias sponsored by certain influential leaders such as Muqtada al-Sadr. Billions of dollars were allocated to reconstruction projects but only a small portion was actually spent while some was embezzled or wasted. Some progress was made toward political and economic recovery but that progress is largely overshadowed by the cost in lives of 7000 Iraqi military servicemen and police, almost 60,000 Iraqi civilians. Between 30 and 40 Iraqi citizens are kidnapped

every day. Almost 4000 American military personnel have been killed as well. Establishing security and rule of law remains a considerable challenge and a high priority even while progress is sought in economic areas.

Progress on the Economic Track:

- Iraq is currently producing an average of 2.1 million barrels of oil per day (2006 figures). This is an increase from 1.58 million bpd in 2003 but analysts do not expect major additions to production capacity for the next 2-3 years.
- Nominal Gross Domestic Product (GDP) increased from \$25.5 billion in 2004 to an estimated \$34.5 billion in 2005 and is projected to rise to \$47 billion in 2006, according to the International Monetary Fund.
- The Iraqi Dinar exchange rate has improved slightly since its 2005 rate of 1,475 IQD/\$1 to 1,237/\$1 in August 2007. The inflation rate stood at 46 percent inflation in June 2006. Core inflation which excludes fuel and transportation is at 19 percent, down from 32 percent last year.⁸⁹
- Per capita GDP was estimated to increase from \$949 in 2004 to \$1237 in 2005 and was projected to increase to \$1635 in 2006.
- Iraq entered a Stand-By Agreement with the International Monetary Fund in December 2005. Third and Fourth Reviews Under the Stand-By Agreement, Financing Assurances Review, and Requests for Extension of the Arrangement and for Waiver of Nonobservance of a Performance Criterion was completed on February 23, 2007. The final review is due in September 2007 but results of the third and fourths reviews look positive.⁹⁰

⁸⁹ Reuters, "Iraq Needs \$100 – 150 Billion for Reconstruction: Finance Minister," *Iraq Directory* (August 21, 2007) <http://www.iraqdirectory.com/DisplayNews.aspx?id=4404> (accessed August 21, 2007).

⁹⁰ International Monetary Fund, "Iraq: Third and Fourth Reviews Under the Stand-By Arrangement, Financing Assurances Review, and Requests for Extension of the Arrangement and for Waiver of Nonobservance of a Performance Criterion—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Iraq," *IMF Country Report* No. 07/115 (February 23, 2007).

- Pledges of reconstruction aid to Iraq total more than \$15 billion as of December 31, 2006. **Note:** less than \$4 billion has been delivered.
- In 2005 there were about 3 million telephone landline and cell phone subscribers in Iraq. By January 2007 that number had increased to 9.8 million. Ninety percent are cell phone subscribers.⁹¹

The Administration acknowledged the multiple challenges remaining in the economic sphere, challenges that corrected will also result in minimizing the shadow economy. These challenges include improving oil production capacity, repairing the neglected and insurgent-damaged infrastructure; developing a payment and banking system suitable for modern domestic and international financial transactions; facilitating a market-oriented economy. Again, security must continue to take a front row seat.

2. International Monetary Fund

Iraq's external debt following the end of the Ba'athist regime was approximately \$125 billion. The Paris Club agreed to forgive 80 percent of Iraq's debt to member countries which totaled \$38.9 billion.⁹² The remaining 20 percent of \$7.8 billion would be rescheduled over 23 years with a six-year grace period. The terms of the debt relief were as follows:

- First reduction canceled 30% of the debt when the Paris Club agreement was signed by both parties;
- Second reduction canceled an additional 30% after an IMF program was signed; and
- Third reduction cancels final 20% of the debt upon completion of the last IMF Board review three years hence.

⁹¹ Special Inspector General for Iraq Reconstruction, "The Year of Transition in Review" (January 30, 2007), 114.

⁹² Martin A. Weiss, "Iraq's Debt Relief: Procedure and Potential Implications for International Debt Relief," *CRS Report for Congress* RL 33376 (December 6, 2006).

The Iraqi Transitional Government entered into a 15-month Stand-By Arrangement with the International Monetary Fund on December 23, 2005. The program which is due for final review on September 28, 2007 is aimed at maintaining macroeconomic stability, laying the foundation for sustainable growth, and in compliance with the Paris Club intentions, to achieving external debt sustainability (reduction of 80% of Iraqi debt to Paris Club members).

The Government of Iraq (GoI) met the conditions of the First and Second Review on August 2, 2006. Staff Appraisals for the Third and Fourth Review indicated the following:

- Economic policies are strengthening but the deteriorating security situation is exacting a heavy toll on the economy. Improved security conditions are essential.
- Spending is under control especially on wages and pensions. Fuel subsidies will be reduced significantly in 2007. A census of public service employees by September 2007 is important. Continued poverty-reducing spending is encouraged.
- GoI's decision to continue raising domestic fuel prices is a strong signal of their commitment to the program. Private sector import of petroleum products is encouraged.
- A strengthening dinar and increased interest rates are a welcome sign but high inflation may require the Central Bank of Iraq (CBI) to make further adjustments.
- The hydrocarbon law should be enacted soon to raise necessary funds for oil production investment.
- Corruption, especially in the hydrocarbon sector, is hurting the economy and damaging the GoI's credibility. Joining the Extractive Industries Transparency Initiative (EITI) is an important step toward greater transparency and good governance.

- Staff recommends approval of the review and request for extension.

For their part the GoI posited that despite the difficult security and political situation progress toward complying with the conditions of the SBA had continued and requested a six month extension to September 2007.

- They also requested a waiver for nonobservance of the structural performance criterion due December 31, 2006 to adopt a budget classification and chart of accounts in line with the IMF's *Government Finance Statistics Manual 2001*.
- GoI is committed to lowering inflation, observing fiscal prudence and undertake reforms leading to sustainable growth. Key will be elimination of fuel subsidies and raising domestic fuel prices in March 2007. Fuel subsidies on premium gasoline have been terminated.

The following points of interest were contained in the supplementary memorandum which accompanied the Iraq Minister of Finance's letter.

- Inflation had peaked at 77 percent in August 2006. Core inflation stayed in the 30-35 percent range.
- The GoI had run a surplus through September mainly due to underspending in investment. Oil revenue was slightly higher than expected due to higher prices. Non-oil revenue was higher than expected due to better-than-expected non-tax revenue and interest earnings.
- The 2007 budget provides for a pension system and a social protection program. Daily hardship allowance for military personnel will be increased to maximum permissible limits. A no-bonus policy and a civil service hiring freeze have been enacted. Fuel import spending will be limited to \$300 million (for kerosene). Oil and non-oil investment spending will double. Transparency and monitoring programs will increase.

- GoI intends to hold the equivalent of ID 3 trillion in assets in the Development Fund for Iraq by the end of 2007.
- To curb inflation, CBI will allow the exchange rate to appreciate gradually as the situation warrants.
- Domestic fuel prices will continue to be raised. GoI has already exited the domestic market for premium gasoline. Regular gasoline (produced locally) will be priced at ID 300 per liter by March 5, 2007 and at ID 350 by June 30, 2007. Government imported premium gasoline will be blended with regular and sold at ID 400 per liter and ID 450 on the same schedule.
- One million poor families have been identified and enrolled in the new social protection program. Expanded coverage is expected. Certain individuals (ministers, members of the CoR, etc) voluntarily removed themselves from the Public Distribution System (PDS) with further limitations to follow. A civil service census of employees will be completed in 2007.
- Eight commercial banks are connected to the CBI via the Real-time Gross Settlement payment system and the automated clearing house with more to follow.
- MOUs have been signed between CBI and MoF for operational restructuring of the state-owned Rafidain and Rasheed banks and financial restructuring of the Rasheed Bank.
- A new hydrocarbon law is under development and the Ministry of Oil is working to implement an integrated system of oil metering.
- GoI is making a concerted effort to implement an anti-corruption strategy, especially in the oil sector. Many suspicious oil contracts have been cancelled.
- GoI is engaging creditor nations to resolve external debt claims.

The International Monetary Fund acknowledged both the Staff appraisals and recommendations. They acknowledged the efforts of the Government of Iraq to comply with the requirements of the Stand-By Arrangement and approved their request for a six-month extension.

3. The Iraq Study Group Report

The Iraq Study Group Report did not bring anything new to the discussion about the economic situation in Iraq.⁹³ It acknowledged some progress but that serious efforts at reconstruction were hindered by, “insecurity, corruption, lack of investment, dilapidated infrastructure, and uncertainty,” a situation most officials were acutely aware of. But a closer examination of the state of the economy would have been beneficial because repairing the economy is a key factor in restoring good governance in Iraq. The size of the shadow economy has grown exponentially as the level of violence has increased. Insurgent groups operate freely in this environment therefore the behavior of these groups can be manipulated through Iraqi participation and by controlling that environment,⁹⁴ much as the National Strategy for Victory in Iraq declares that we will deny the enemy safe havens from which he can operate and to which he can retreat.

The report dismisses the proposal to distribute a portion of oil revenues to Iraqi citizens citing the lack of a verifiable means of ensuring equitable distribution as reasons for not supporting the recommendation. The amount of time it would take to conduct an accurate census of the population and a reliable income tax system is viewed as problematic. Further, the oil revenues have already been incorporated into the state budget in the out years.⁹⁵

There are several U.S. organizations involved in reconstruction efforts including the Defense Department, State Department, United States Agency for International

⁹³ James A. Baker, III and Lee H. Hamilton, Co-Chairs, *The Iraq Study Group Report* (New York: Vintage Books, 2006).

⁹⁴ Robert Looney, “Beyond the Iraq Study Group: The Elusive Goal of Sustained Growth.” *Strategic Insights VI 2* (March 2007) and Abbas Kadhim, “Shi’I Perceptions of the Iraq Study Group Report.” *Strategic Insights VI 2* (March 2007).

Development (USAID), plus others. The Iraq Study Group report states their efforts are uncoordinated and ineffective with no clear delineation of responsibility. It is not clear who is in charge of reconstruction in Iraq, including the Iraqi Government. Recommendation 67 advised the President to appoint a Senior Advisor for Economic Reconstruction in Iraq to bring unity of effort to the policy, budget, and implementation of economic reconstruction programs in Iraq. The short term efforts of the Commander's Emergency Response Program are lauded while the long term efforts of USAID are viewed as being susceptible to funding shortages in the future.

The seven Provincial Reconstruction Teams (PRTs) organized under the State Department to help develop the capacity of Iraq's provincial governments, were viewed as promising, if curtailed by security constraints. The State Department has already begun to increase the number of PRTs in Iraq from seven to twenty-five. All twenty-five teams are expected to be fully staffed by December 2007. The additional PRTs will be more mobile, assigned within Brigade Combat Teams (BCT) to allow for more work to be done at the district and municipal levels, even in dangerous areas. The PRTs and embedded PRTs (ePRT) show measurable progress in accomplishing their mission. According to the SIGIR report, the expanded PRT program will double the number of U.S. civilian personnel in key areas of the population and their decentralized efforts will help accelerate the transition to Iraqi self-reliance. The PRTs are also working with other U.S. reconstruction program managers under the direction of the National Embassy Team for a more coordinated effort.⁹⁶

4. Conclusions

The New Way Forward was a necessary strategy adjustment on the part of the Bush Administration. It came after almost four years of intense fighting in Iraq, political turmoil within the Cabinet of Representatives, and little progress in reconstruction. The insurgency continued to grow. Muqtada al-Sadr's militia replaced police and other

⁹⁵ James A. Baker, III and Lee H. Hamilton, Co-Chairs, *The Iraq Study Group Report* (New York: Vintage Books, 2006), 24-25.

⁹⁶ Special Inspector General for Iraq Reconstruction, "The Year of Transition in Review," (January 30, 2007), 63-70.

government services in Sadr City and reigned freely literally paralleling the GoI in his area. The Shadow Economy continued to grow and provided an excellent logistical platform for insurgents, organized crime, profiteers and black marketers.

There are many possible factors for this situation to have come about; faulted strategy, poor coordination of effort, lack of support for the government, inadequate knowledge of Iraqi culture, lack of motivation, etc.. But one theme that gets the most attention in all of the policy documents, agreements and studies outlined above is corruption and widespread violence. Everyone agrees that these are the major obstacles preventing successful reconstruction and sustainable growth. Delivery of international reconstruction aid has been withheld because of it. The International Compact with Iraq has made little progress because Iraq's neighbors and other future international trading partners are hesitant about investing in the country because of the lack of transparency, corruption and violence.

A good argument exists for winning the hearts and minds of the Iraqi people and thus controlling the Shadow Economy by weaning them away from the informal economy. One way to do this is to distribute oil revenues equitably to make Iraqi citizens more financially stable so they can purchase the food, medical care and proper homes they need. Other reconstruction efforts will still have to continue of course, because the infrastructure is still largely in disrepair and if Iraqi's are to pursue other things such as education, better jobs, etc. they need to be able to focus on other things besides illness and habitability problems.

In this regard, there are initiatives underway to improve living conditions using a bottom-up approach, namely CERP and PRTs. The mission of the PRTs is briefly described above. Launched in 2005, the mission of these teams is important but they are still few, even considering that eighteen new teams will be deployed by the end of 2007. More can be done with units such as these. CERP was created to allow U.S. military commanders to respond rapidly to urgent humanitarian, relief and reconstruction needs. The total budget for this program for fiscal years 2006 and 2007 was slightly less than \$1 billion. Multi-National Corps Iraq is the program coordinator. Subordinate commanders have contract approval up to \$500,000. Projects are selected based on how quickly they

can be accomplished, the number of Iraqis that will be employed; the number of Iraqi citizens that will benefit, and the visibility of the project. Some areas that have benefited are water, economic development and electricity. CERP is a ground level small success story. Since 2004 military commanders contracted 11,670 projects, the majority of which (7,638) were funded in fiscal year 2006 and 2007 and 68 percent of the projects are complete. Notably, many of the projects were completed in four of the six areas DoD has identified as being the most violent provinces in Iraq. The high turnover rate of personnel within MNC-I was considered a negative aspect in relation to CERP but since 2004, military commanders have been coordinating their projects with the National Embassy Team.⁹⁷

The high-level strategy aimed at reconstructing Iraq at the macro level is important and efforts should continue. At the same time, however the present needs of the individual Iraqi citizen, man, woman and child, must also be tended to. Reducing subsidies on fuel and imposing an income tax do not endear an unemployed, hungry person towards the long term strategic plan.

⁹⁷Special Inspector General for Iraq Reconstruction, "The Year of Transition in Review," (January 30, 2007), 37-39.

IV. CASE STUDY: WHAT CAN BE LEARNED FROM ATTEMPTS TO CONTROL THE SHADOW ECONOMY IN AFGHANISTAN

A. INTRODUCTION

There are lessons to be learned from studying government, Coalition, and international community efforts to control a similarly embattled economy in Afghanistan. Experience obtained in that environment can be examined and successful approaches applied to establishing control over the Shadow Economy in Iraq.

The two countries have several things in common that make Afghanistan an enlightening economic benchmark study despite the fact that Afghanistan's main export is opium, an illegal drug. Approximately ten percent of the population is actively involved in planting, harvesting, processing or smuggling aspects of the opium trade. The opium trade provides Afghans with approximately \$3.1 billion dollars annually. Farmers earn a net profit of \$4000 to \$6000 per hectare, up to ten times that of any other crop. Other harvests bring in significantly less; maize (\$1650), vegetables (\$665), cotton (\$650, and wheat (\$450). Therefore speaking practically, opium is integral to Afghanistan's economy, albeit informal for the foreseeable future. Further Afghanistan is plagued by security concerns, government corruption, and a lack of reasonable alternatives which make it unlikely that Afghans will willingly switch to other agricultural crops. Table 4 compares circumstances in the two countries that have been used as the basis for this case study. They have both been freed from rule by repressive regimes and both have a sizable shadow economy. Security and reconstruction efforts had been underway for two years in Afghanistan before the coalition force invaded Iraq. Controlling the shadow economy in Afghanistan and Iraq is a key milestone to successful reconstruction and restoration of peace and stability. Lessons learned in that environment can be valuable in restoring Iraq's formal economy.

Table 4. Comparison between Economic Situations in Afghanistan and Iraq.⁹⁸

	Afghanistan	Iraq
Regime Type Prior to Invasion by Coalition forces	Authoritarian	Dictatorship
Coalition Force Takeover	Sep-01	Mar-03
Population	31 million (est)	28 million
Per Capita GDP	\$800	\$1,635
Labor Force	15 million	7.4 million
Unemployment Rate	40%	27-40%
Percent Living Below Poverty Level	53%	49%
Inflation Rate	16%	50-64%
Main Export	Opium	Oil

B. BACKGROUND

In 1988 the Soviet Union agreed to create a neutral Afghan state. The last of the Soviet troops left Afghanistan in 1989 having occupied the country for ten years. The agreement and subsequent withdrawal ended a war that had killed thousands, devastated industry and agriculture, and created five to six million refugees. Internal strife remained between the government and the mujahideen and in 1992 the country descended into civil war further ravaging the economy. The struggles continued until one Islamic fundamentalist group, the Taliban, gained control of most of the country. From 1996 on the Taliban used an extremist interpretation of Islam to assert repressive control of society. The economy remained in ruins and operation of most government services ceased.

The Taliban granted the Arab terrorist organization, al Qaeda, the right to use Afghanistan for recruitment, training and as a base for terrorist attacks in many parts of the world. Al Qaeda committed a series of international terrorist acts which as we know culminated in attacks on the United States on September 11, 2001. When Mullah Omar, leader of the Taliban refused to surrender al Qaeda leader, Osama Bin

⁹⁸ Information for this table was derived from the following sources. Reuters AlertNet, "Iraq: Unemployment and Violence Increase Poverty." *Source IRIN* (October 17, 2006) <http://www.alertnet.org/thenews/newsdesk/IRIN/c14c2cc0f6c99e87f284df922a039cad.htm>. (accessed August 8, 2007) and CIA World Fact Book. <https://www.cia.gov/library/publications/the-world-factbook/geos/iz.html>. (accessed August 8, 2007), and Michael O'Hanlon and James Campbell "Iraq Index: Tracking Variables of Reconstruction and Security in Post-Saddam Iraq," *The Brookings Institution* (May 10, 2007).

Laden who was believed to be responsible for the atrocities, the United States and its allies attacked Afghanistan. The Taliban government collapsed, its exiled leaders later signed the Bonn Agreement. In 2002 Hamid Karzi was selected to lead the country and was elected president in October 2004. Despite substantial international aid the multi-factional Afghan government was unable to address the numerous social and economic problems facing the country.⁹⁹

Afghanistan shares economic cultural, political, social, religious, historical and geographical similarities with the country of Iraq. They both fought ten-year wars in roughly the same period. Both have a major resource that dominates the economy – opium in Afghanistan and oil in Iraq. Their population is approximately the same size; between 28 and 31 million. Both countries are almost entirely landlocked (Basra is Iraq's only sea port, Afghanistan is landlocked) and reside along trade routes used for a millennium for legitimate and illegitimate trade. Afghanistan and Iraq are Muslim countries. More importantly for the purposes of this discussion, Afghanistan and Iraq both have well-established informal economies. Since the two countries are still in the process of reconstruction it is instructive to examine the steps taken to formalize the economy in Afghanistan and assess their possible application in Iraq.

1. Discussion

As discussed earlier, the informal economy can be subdivided into three components or phases with different actors and varying levels of illicit activity occurring in each. They are the combat economy, the shadow economy, and the coping economy. They are not necessarily separate; there is a significant amount of overlap and they can frequently coexist depending on level of the actor or activity.¹⁰⁰

⁹⁹ Federal Research Division, "Library of Congress Country Profile: Afghanistan," *Library of Congress* (February 2005).

¹⁰⁰ Jonathan Goodhand, "From War Economy to Peace Economy? Reconstruction and State Building in Afghanistan," *Journal of International Affairs* 58 1 (Fall 2004).

- The combat economy becomes well developed for resource production, mobilization and allocation to keep a conflict going. Economic strategies to undermine specific groups, i.e. the government, are also present here.
- The shadow economy supports economic activities that are performed outside of state-regulated frameworks. These activities are not audited by state institutions due to a lack of effective institutions or corruption, or both. Actors include profit-seekers who might be interested in peace but only so much as it benefits them.
- The coping economy consists of population groups trying to maintain their survivability.

In his article on this subject, Jonathan Goodhand states that a war economy is both a cause and consequence of the current crises, meaning that it serves as an enabler for war. As hostilities expand and contract, different phases of the informal economy become more prominent. For instance, as violence ebbs and flows the economy moves through the different stages, i.e. from coping to shadow, then escalating to support a combat economy and down again after hostilities end. All manner of individuals maneuver their way through this free flowing economic mainstream; the poor, profiteers, elements of organized crime, and insurgents operate within this realm to subsist, buy and sell goods on the black market, obtain guns, ammunition, transportation and communications, launder money, raise funds, etc. Goodhand further states that war economies empower border areas. Another way to look at is that weak states who fail to achieve positive control over their borders or otherwise fail to impose rule of law over the population create opportunities for motivated parties to control the flow of goods throughout key areas of the country. In the case of Afghanistan, tribal leaders or warlords have been able to dominate border areas because of weak governance and profited by supporting opium production and smuggling goods in and out of the country. Intense competition exists over continued control of these areas. Sophisticated smuggling networks have evolved to transport opium and heroin to markets around the

world. There are hundreds of unofficial border crossing points between Afghanistan and neighboring countries making it relatively easy to move product to support the drug industry from both sides of the border.

Refugees also factor into Afghanistan's shadow economy. At one time almost five million Afghans sought refuge in neighboring countries with the majority living in Pakistan and Iran.¹⁰¹ The number has decreased since reaching its peak in 1986 but more than half of the five million are still in exile. In addition to depriving the country of invaluable human capital, these people are well-situated to support cross-border smuggling efforts to and from Afghanistan. Refugees began arriving in numbers in Pakistan in 1979; by October there were an estimated 200,000 and by then of 1980 a full million. That number doubled in 1981 and continued to increase to 3.2 million in 1990.¹⁰² It is claimed that several hundred thousand were not counted, either to escape detection or because of administrative oversight. Most of the 2.3 million refugees who settled in Pakistan live in the North-West Frontier Province where there are at least 27 known unofficial border crossing points. A third of the unofficial border crossing points service major opium-producing provinces (Hilmand, Nangahar, Laghman, and Kunar).¹⁰³ Afghanistan is permeated by corruption. For instance customs officials can demand as much as \$400,000 to close the border checkpoints for a few hours to allow drugs and other illicit materials to pass undetected.¹⁰⁴

Efforts to gain control of the economy so that reconstruction can begin in earnest have met with varying degrees of success. Since 2006, the number of opium-free provinces has doubled from six to thirteen, in north and central Afghanistan. Despite widespread poverty, leadership incentives and security have persuaded farmers to grow different crops. It is a different story in the south and west regions of the country

¹⁰¹ Hiram Ruiz and Margaret Emery, "Afghanistan's Refugee Crisis," *Middle East Report Online*. (September 24, 2001) <http://www.merip.org/mero/mero092401.html> (accessed September 3, 2007).

¹⁰² Giles Dorronsoro, *Revolution Unending: Afghanistan: 1979 to the Present* (New York: Columbia Press University, 2005), 167-168.

¹⁰³ United Nations Office of Drugs and Crime, "Afghanistan 2007 Annual Opium Poppy Survey: Executive Summary (August 2007) <http://www.unodc.org/unodc/index.html> (accessed September 2, 2007).

¹⁰⁴ Tom Johnson, "Opium Production and Transport" (lecture, Naval Postgraduate School, Monterey, CA, August 28, 2007).

particularly in the five provinces that border Pakistan. Seventy percent of the country's opium was grown there and 50 percent of it was grown in the Hilmand province. This comparatively wealthy province now has the distinction of being the largest source of illicit drugs. UNODC's annual report, source of the preceding data, also makes three observations pertaining to Afghanistan's drug trade, a) opium cultivation is no longer associated with poverty, b) the industry is closely linked to the insurgency, as the Taliban controls several key opium cultivation areas, and c) the Taliban have completed a role-reversal from their successful July 2000 stance against opium cultivation, to present-day encouragement of growth to fund their operations.¹⁰⁵

The plan offered by UNODC to legitimize Afghanistan's economy, and what interests us for Iraq, is a multi-faceted plan that consists of both macro- and micro-level conditions.

- Increase rewards to non-opium farmers. Build on successes in the north by rewarding new partners immediately with hospitals, schools, water and power.
- Minimize risk for poorer opium farmers adversely affected by 2007 eradication programs. Poor farmers in marginal areas were more likely to have their opium crops destroyed because of corrupt deals between field owners, village elders and eradication teams. In 2008, target rich landlords in southern Afghanistan proliferation is greatest.
- Increase the number of opium-free provinces. Eliminate drug trade in those provinces as well. Evidence indicates a gravitation toward refining and trading where opium cultivation has ceased. Contain opium cultivation in as small an area as possible, i.e. the south where efforts can be concentrated on insurgents and drugs.

¹⁰⁵ United Nations Office of Drugs and Crime, "Afghanistan 2007 Annual Opium Poppy Survey: Executive Summary," (August 2007) <http://www.unodc.org/unodc/index.html> (accessed September 2, 2007).

- Have NATO destroy opium labs, disrupt markets and capture traffickers. Drug trafficking and insurgents share a symbiotic relationship that can be manipulated to lower demand.
- Coherence in policy. Work to end the wide-spread corruption that permeates Afghan society and facilitates drug-related general profiteering.
- Strengthen the judicial system by trying and convicting major drug dealers instead of just the low-level participants. Add drug traffickers' names to international most-wanted list authorized by UNSC Resolution 1735 (2006).
- Encourage cross-border cooperation and garner international support for initiatives such as the Triangular Initiative between Afghanistan, Pakistan and Iran. This is a joint agreement to block smuggling, increase law enforcement, run joint operations and share intelligence in the war against the drug trade.
- Lower foreign demand for Afghan opium. Governments of opiates consuming countries in the European Union, Commonwealth of Independent States and China need to act.

I identified six lessons that can be taken away from reconstruction and stability experiences in Afghanistan and applied in Iraq with some measure of success. For balance however, let us first address the issue of refugees from Iraq. Iraq's refugee population has not reached the size of Afghanistan's yet. Current estimates place the number of Iraqi refugees at two million, with about 1.9 million residing in Syria and Jordan, and the rest scattered in Egypt, Lebanon and Turkey.¹⁰⁶ Iraqi borders were guarded closely for decades and only recently has a significant Iraqi refugee population begun to develop. While the Afghanistan/Pakistan border has been empowered as a result of conflict and weak rule of law, Iraqi refugees fleeing deteriorated security conditions have just begun to organize themselves to support cross-border illicit trade.

¹⁰⁶ Nir Rosen, "The Flight From Iraq," *The New York Times* (May 13, 2007). www.nytimes.com (accessed May 13, 2007).

This is not to say Iraqi refugees are all criminals but the conditions and pressures they exist under lend themselves to participation in the shadow economy.

First, offer reasonable alternatives to participants in Iraq's shadow economy. Current efforts focus on eradicating the opium trade in Afghanistan without offering an acceptable alternative alienates Afghan farmers, traders and black marketers making them less inclined to transition their skill sets into a formal sector. Ninety-eight percent of Afghan farmers indicated a willingness to stop opium cultivation if they had other alternatives. A quarter of those surveyed preferred jobs away from the farm, while another quarter preferred alternative crops.¹⁰⁷

Second, capture and redirect the talents that exist in Iraq's shadow economy. It takes the same type of leadership, business sense and entrepreneurial spirit to survive in the informal economy as it does in the formal economy. Funding insurgent operations in Afghanistan or Iraq requires this kind of talent and if the violence can be reduced that human capital can be redirected to help the formal economy prosper.

Third, capitalize on successes. In 2007 the Laghman and Kunar provinces achieved a decrease in opium cultivation of 21 and 56 percent, respectively below 2006 levels. The number of opium-free provinces grew from 6 to 13 (of 34) from 2006 to 2007.¹⁰⁸ Similar achievements should be reinforced in Iraq. The SIGIR reported several successful projects and initiatives completed by Iraqis which were organized and funded by various government agencies, including CERP and PRTs.¹⁰⁹

Fourth, identify key players and determine what motivates them to participate in the shadow economy and act on this information to obtain desired results. The UNODC 2007 Opium Survey collected responses from farmers on both sides of the issue; those who participated in opium cultivation and those who chose not to. The top three reasons for non-cultivation were religion (38%), illegal crop (28%), and respect for shura/elder

¹⁰⁷ United Nations Office of Drugs and Crime, "Afghanistan 2007 Annual Opium Poppy Survey: Executive Summary," (August 2007) <http://www.unodc.org/unodc/index.html> (accessed September 2, 2007).

¹⁰⁸ Ibid.

¹⁰⁹ Special Inspector General For Iraq Reconstruction, "Quarterly Report and Semiannual Report to the United States Congress," (July 30, 2007), Section 2.

decision (18%). In 2007 fear of crop eradication joined the top three reasons for discontinuing opium cultivation (16%). The main reasons for participating poppy cultivation in 2007 were to escape poverty (29%) and to take advantage of high opium profitability (25%).¹¹⁰ Though the situation is moderately different in Iraq, personnel staffing agencies on the ground are in the best positions to gather and make use of this type of intelligence.

Fifth, treat the security condition and the shadow economy as being integral to each other and proceed accordingly. In Afghanistan the Taliban and other criminal elements guard their opium fields and drug trade zones closely, frequently resorting to violence. Control over smuggling routes, turfs, trade goods, markets, etc. in Iraq are also jealously guarded. In addition, the insurgency in Iraq aggressively attempt to destroy infrastructure thus undermining reconstruction efforts. Here a two-prong approach is warranted; work to formalize the shadow economy while simultaneously containing and stopping the insurgents. Given the number of hard-won achievements thus far, this is an extremely difficult undertaking at best.

Sixth, beware of addiction to and corruption of international aid. International aid contributed to Afghanistan becoming a rentier state with Afghans becoming reliant on NGO's for employment as well as relief. Before September 11, 2001, aid organizations employed 25,000 Afghans.¹¹¹ Prior to this, in the 1980's humanitarian assistance went directly into the combat economy. Iraq faces similar risks until the oil industry recovers and profits are used equitably for the entire country's benefit. However, once the oil industry is restored to its pre-war levels it could very well revert to an oil rentier state.¹¹² Countries with major resources such as oil tend to focus almost exclusively on generating

¹¹⁰ United Nations Office of Drugs and Crime, "Afghanistan 2007 Annual Opium Poppy Survey: Executive Summary," (August 2007) <http://www.unodc.org/unodc/index.html> (accessed September 2, 2007).

¹¹¹ Jonathan Goodhand, "From War Economy to Peace Economy? Reconstruction and State Building in Afghanistan," *Journal of International Affairs* 58 1 (Fall 2004).

¹¹² Robert Looney, "Can Iraq Overcome the Oil Curse?" *World Economics* 7 1 (January-March 2006).

income from that resource and ignoring development in other key industries. There is also a greater possibility of civil war as discontent grows over slower growth, poverty, corruption, and authoritarianism.¹¹³

C. RECOMMENDATIONS

Afghanistan and Iraq share many economic similarities. They are both challenged by deep cleavages within the political structure, powerful tribal groups, and an aggressive insurgency. Both are potential rentier states with only one major income-producing export, each. In Afghanistan it happens to be an illegal drug but in Iraq a licit natural resource has been subverted to support the shadow economy. Additionally, the two countries exist with a significant number of refugees living outside of their borders. Both have complex, decades-old shadow economies.

Creating a stable security condition in Afghanistan and Iraq appears to be the overriding priority. This is a recurring message throughout all of the studies, inspections and articles examined for this thesis. For obvious reasons security draws a lot of attention indicating the need for an armed force and police force capable of defeating the enemy. But every effort should be made to develop cohesive, fair and strong governance in Iraq complete with effective institutions. Weak governance has been evident in Afghanistan since the Taliban was ousted and is evident in Iraq today. A strong well-run government can establish rule of law, political stability, regulate the economy, enforce laws and prosecute criminals. A strong state can reduce the widespread violence and exploitation. Further a strong government can enforce its right to sovereignty and withstand intervention by regional powers. Controlling excess intervention in Afghanistan's affairs by Pakistan and by Iran within Iraq will positively affect the security and economic situation. This is a valuable lesson to take away as the Iraqi government and the coalition force struggle continues.

Decisive measures must be taken to formalize Iraq's shadow economy while the insurgency is contained and eradicated. Taming the shadow economy is arguably just as

¹¹³ Robert Looney, "Can Iraq Overcome the Oil Curse?" *World Economics* 7 1 (January-March 2006), 25.

difficult a task as quelling the insurgency but it must be done simultaneously otherwise the energy will be harnessed by other illicit entrepreneurs allowing the shadow economy to flourish unimpeded. Providing social insurance, security and growth is challenging and will require full support for plans already developed by the Iraqi government, coalition forces and international aid organizations committed to helping Iraq. The private sector alone does not possess the incentive and motivation to formalize a shadow economy. As we have seen in Iraq, businesses are quick to take advantage of corrupt officials, inefficiencies within the government and are seemingly satisfied to operate in the informal economy. Again, key leaders within the shadow economy should be engaged and their talents harnessed to bring about change. A modern and reliable infrastructure is needed that businesses and normal citizens can use to perform everyday tasks and that nurture robust growth. The Afghan police force is reportedly 90 percent corrupt. Steps should be undertaken in these comparatively early stages in Iraq to root out corrupt officials and bring them to justice as a warning to others regardless of their status within the government.

Reversion to an oil rentier state must be avoided. Iraq already has a rentier state history albeit of a different type which affects Afghanistan. Early in this document initiatives implemented by Saddam Hussein in the early 1970's were described for full employment, increased educational opportunities, infrastructure modernization etc. These largely successful but short-lived efforts were funded by profits from oil sales. However, dependence on oil revenues extended well beyond that and before long the entire society was content to live off the proceeds of oil sales. As a result it became a rentier state. Since the Iran/Iraq war oil production has withered and twenty years later has still not reached pre-war levels leaving a non-productive economy, save what reconstruction efforts have achieved. Regardless of whether rentier state status derives from too much uncontrolled international aid, or over reliance on government employment and subsidies, a rentier state economy still falls far short of a self-sustaining economy. Which is what is needed in Iraq.

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V. CONCLUSION

The Iraqi people are a good people with much to offer the international community. They have high social standards, are devoutly religious and want better lives than they have been allowed over the past few decades. In most cases the shadow economy has been the only means by which to eke out a living because the Ba'thist regime was more intent on building and maintaining power than on the welfare of its citizens. Unfortunately the shadow economy has proven to be a liability for Iraq, one that needs to be transformed into an asset so that the country can move forward and take its rightful place on the world stage.

Attempts to change Iraq's course; to install a new government of democratically elected Iraqi leaders, and to achieve security, peace, and stability has been a daunting challenge for everyone involved over the past four years. There are many parties who wish to dominate on the political scene and not enough who wish to work together. Insurgent violence and corruption are the major stumbling blocks that must be faced down in order for progress to occur. The tie that binds is the Iraqi economy and in particular, the shadow economy that arose as a result of the vacuum created by a negligent regime and multiplied exponentially by war, economic sanctions, corruption and internal strife. The Iraqi people must be convinced through deed and leadership that transition to a formal economy, however painful it may be at the outset, is in their best interest, and they must be led in that direction.

How best to do it remains the question. After analyzing the strategy documents, the commitments of the Iraqi government and the multitude of writings by learned scholars and daily media reports of occurrences related to Iraq one can but realize that there are many right answers and many wrong answers. The correct solutions for gaining control of Iraq's shadow economy to move Iraq forward in the right direction is a combination the initiatives already in place, as well as a few more. Iraq is a country of 28 million people, two million of which are now refugees in neighboring countries. They are all facing extreme circumstances from hunger to poverty, to insufficient healthcare, to

daily life-threatening violence, and need a government they can have confidence in. They need a government who will provide social welfare, social insurance, adequate security and solid institutions. But trust is not a trait that comes easily to them after so many years of oppression, and not so when there are so many other basic concerns.

Transformation from the shadow economy (the term I use to encompass coping, shadow and combat economies) needs to be all inclusive. First, transformation must be led by the Government of Iraq from the top down using a macroeconomic approach. The government must bear the responsibility for recreating itself. The President, Prime Minister and entire Cabinet of Representatives have to pledge to work out their differences, and then do so. They have to create a legitimate atmosphere of transparency to persuade Iraqi citizens the government works for them. The People of Iraq need to hold the government to task and ensure they perform for the purpose and at the level for which they were elected. The People of Iraq need to support their local communities as the communities strive to support them.

The government has to make state-owned enterprises more efficient or consider privatizing them as is planned for premium gasoline in the future. Bank modernization should continue and then be given the mission of attracting customers on a large scale and finance new businesses through small business loans and micro loans. The commerce department should set about registering all businesses so they can be equitably taxed to capture revenue for the state. This is just a small sampling of the many agencies the government can use to lead the country effectively. Strong leadership is a non-negotiable requirement to carry out this transformation. Further, rule of law must prevail.

Primary and secondary school educations should be made available in all areas of the country and attendance made mandatory for all school-age children. Vocational and technical schools are necessary to develop a qualified workforce capable of sustaining infrastructure currently being rebuilt throughout the country. A good educational system should be a major underpinning of Iraqi society. Large scale illiteracy will continue to be a major detriment to successful reconstruction and good governance efforts until a new generation of graduates emerges to boost the economy. Projects such as those funded by Iraq Relief and Reconstruction Fund 1 and 2 (IRRF) and carried out by USAID, DoD,

Department of State, Department of Treasury, and the U.S. Trade and Development Agency, and of course the Government of Iraq, will become ideal career and employment opportunities for graduates of these institutions.

Transformation must also be led by the Government of Iraq from the bottom up using a microeconomic approach.¹¹⁴ The private sector cannot fix the shadow economy but an environment can be created by the government which will encourage the private sector to pursue legitimate means of making a living. Micro-loan financing has proven effective in other Middle Eastern, Latin American and African countries to help poverty-stricken individuals open small businesses. The desired effect will be to increase the number of legitimate, properly regulated businesses with the hope that they will thrive, and open employment opportunities for others within their community and eventually grow large enough to incorporate. Reconstruction projects are a good source of employment for many Iraqis.

The signs are positive that the Government of Iraq will comply with the International Monetary Funds stipulations dictated in the Stand-By Agreement and will have a large portion of their external debt forgiven. Successful completion will reduce Iraq's debt to Paris Club members from \$38.9 billion down to \$7.8 billion, or 80 percent of the original amount owed.¹¹⁵ (Debt forgiveness occurred in three phases with 60 percent of the debt being forgiven in the first two stages and the final 20 percent in the third stage). Once complete Iraq's external debt will have been reduced from approximately \$120 billion to \$72 billion.¹¹⁶ Vastly important, it frees up a significant amount of money that can be used to build up a robust, formal economy and service other non-Paris Club debt.

The Government of Iraq is making progress toward eliminating petroleum product subsidies. Making the price of gas and oil comparable to those found in neighboring

¹¹⁴ U.S. Department of State, "Microfinance Builds Iraqi Economy," (January 10, 2007). www.state.gov (accessed August 22, 2007).

¹¹⁵ Martin A. Weiss, "Iraq Debt Relief," *CRS Report for Congress*. RS 21765 (March 11, 2005).

¹¹⁶ Michael E. O'Hanlon and James H. Campbell, "Iraq Index: Tracking Variables of Reconstruction & Security in Post-Saddam Iraq," *The Brookings Institution* (May 10, 2007), 41.

countries will help reduce oil smuggling as profits from this illicit activity are minimized. Significantly, it should also take away an important source of funding for insurgents and reduce damages to oil pipelines and pumping stations. Done in tandem with efforts mentioned above to formalize the shadow economy, Iraqis should be able to find employment find suitable employment to afford the higher gas prices.

The public has to be incrementally weaned off of Public Distribution System (PDS) food supplements. Developed during the sanctions period it is very effective at delivering food to the poor and the non-poor. In 2005, 95 percent of Iraqi households received food rations, an indication of a grossly inefficient system and a prime target for corruption. According to the World Bank, it costs \$6.30 to transfer \$1 worth of food to a poor person. In addition to providing nutrition, it also increased household purchasing power by 30-50 percent.¹¹⁷ However this comes at a high cost the government, consuming as much as 21 percent of its revenue. In 2005, \$4 billion dollars was allocated to the PDS, funds that could be spent in other key areas. Because the PDS is such a large program it has the follow-on affect of depressing food prices on the open market and thus on the economy as a whole.

Three methods have been suggested to eliminate the PDS; rapid elimination, universal cash transfers, and means tested targeting.¹¹⁸ Rapid elimination will result in mass starvation and cannot be seriously considered at present. Universal cash transfers save little money for the government and means testing households throughout the country is still not possible due to security concerns. The World Bank recommended a combination of these plans. They recommended targeting needy recipients, reducing the number of items in the food basket, increasing the role and capacity of the private sector in food sales, and improve procurement and financial management practices.¹¹⁹ Initially, a means tested system of monetary distribution was implemented to provide the poor-poor with at least \$2 per day in addition to the food basket. When the time is right the

¹¹⁷ World Bank, "Considering the Future of the Iraqi Public Distribution System," *Economic and Social Development Unit, Middle East Programme*, (New York, 2006).

¹¹⁸ Ibid.

¹¹⁹ Ibid.

ideal means of providing social support for the poor will universal cash transfer because it will draw Iraqi citizens to post offices and banks to collect their checks. However for the time being every effort should be made to provide PDS only to persons with a valid need.

At the outset of this thesis I set out to examine the combined efforts of the Government of Iraq, Coalition forces and the international community to reconstruct Iraq and in the process formalize a sprawling, and growing, shadow economy. Needless to say there are a multitude of agencies deeply committed to raising Iraq from failed state status, back from the brink of civil war. After conducting a comprehensive review, I found little fault in their efforts even if at the outset there appeared to be some lack of coordination between the various agencies. The various departments organized themselves into information-sharing entities or even better, coordinated their projects under umbrella agencies.

Neoliberalism was attempted too soon after the fall of the Ba'ath regime. The private sector could obviously not correct the deeply embedded problems of the economy in the absence of efficiently functioning institutions or without basic infrastructure such as electricity, water and sewage treatment facilities.

Even though extensive progress has been made, rampant corruption and continued insurgent violence are the two main obstacles to formalizing the shadow economy. They will continue to destroy Iraq until the government and the people take control of their country. Differences must be set aside. This duly elected government must impose its will throughout all regions of the country. Only then can meaningful economic progress be made.

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